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WITH AN INTRODUCTION BY
SIR WALTER LAYTON
C.H., C.B.E.

SECOND EDITION

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A MAN

—ALBEIT AN EDITOR

THE INVOLUNTARY SHARER OF RESPONSIBILITY

FOR BRINGING THIS BOOK INTO EXISTENCE

INTRODUCTION

BY

SIR WALTER LAYTON, C.H., C.B.E.

MR. PARKINSON has written a book which will well repay study by all who have the responsibility for looking after investments, whether they be small capitalists who have their own modest savings to safeguard, or directors of trust companies who deal in millions. No one will read this book without realizing that its author not only possesses a very wide knowledge of his subject, but is a man of judgment. Even in the more technical chapters the book is easily followed by the reader, largely because the author is himself deeply interested in his subject, and obviously enjoyed writing every word of it.

But apart from its technical merits, this book is of interest because it brings together and sets out clearly and simply up-to-date methods of critically analysing balance sheets, establishing the long-range value of various classes of investment and subjecting securities to new and searching tests.

Two valuable ideas which deserve specially to be underlined figure largely in Mr. Parkinson's exposition: one is the importance of ascertaining the capital effectively employed in a business—as distinct from the capital as shown in the balance sheet—and the other the conclusions that may be drawn from the trend of earnings—as distinct from the earnings of a particular year—as revealed by statistical studies over a period of years.

In the course of the argument many old traditions receive short shrift. Mr. Parkinson, for example, does not hesitate to expose the weaknesses of the Preference share, particularly at times of economic instability and wide fluctuations in prices like the present. Again, he points the moral of the

events of the last few years, which have revealed the danger which the investor runs by relying on specific security for Debentures whose value, like that of shares, must depend in the great majority of cases on earning power.

In such matters as company accounts and Stock Exchange organization, Mr. Parkinson is a reformer who is not afraid of radical solutions. All these things are matters of interest not merely to the individual investor, but to the nation as a whole; for it cannot be too often repeated that the process of investment determines the use to which the resources of the community are put, and that if these resources are misapplied or wastefully used the whole of Society suffers.

In short, this book represents the result of several years' close, personal experience. If it succeeds in stimulating investors to take a more intelligent and, above all, a more active interest in the investments which they control, it will have performed a public service.

W. T. LAYTON.

PREFACE
TO THE SECOND EDITION

THE first edition of this book was published during an economic blizzard of Antarctic intensity, whose abatement is scarcely perceptible as the second edition goes to press. Company-earning power, inevitably, has declined, in common with other indices of economic well-being. The accounts of a sample of nearly 2,000 British companies, published last year, show a decline in profits of 18 per cent. Almost without exception, however, the companies whose results, before the slump, most closely satisfied the criteria laid down in this book have shown outstanding powers of resistance. Many have maintained their earnings, and others have recorded a less than average decline. A severer negative test of the soundness of the methods suggested could scarcely have been devised. Investors will trust that a revival of world trade may enable them to make a trial of a very different order in the near future.

H. P.

LONDON, E.C.4
January, 1933.

PREFACE
TO THE FIRST EDITION

It is regrettable that the science—or art—of investment has no body or soul of its own, but is parcelled out among numerous other professions, including the Law, Accountancy and "Tipstercy." These professions, with interests of their own, regard investment at best as a stepchild, and at worst as a mistress.

The position resembles that which would arise if Music were merely a joint appanage of physics professors, writers on counterpoint and form, and sellers of pianos. The lawyer is interested in the thousand and one details involved in starting and terminating a company's existence, and keeping everybody concerned with it either in or out of Court in the interim. The accountant is a photographer of its financial operations, who records, but seldom initiates. The tipster is—well, the tipster.

The real spokesmen for investment—who are supposed to examine all its phenomena and announce broad and helpful conclusions—are usually either stockbrokers or outside writers. Brokers put in a good deal of hard, painstaking and thankless work for their clients, but they are interested chiefly in the buying and selling aspect. Their approach to the problem, in other words, is purely empirical. Outside their offices are numerous official and unofficial advisers, who, with varying degrees of responsibility, put their followers on this or that share which takes their fancy.

It is high time that investment assumed an independent existence, and began to build up its own system of general principles, based on scientific analysis. The object of the present work is to discuss certain methods by which statistical analysis and common sense may be brought to bear on

investment problems, and to formulate some of the "laws" of investment which emerge. The treatment is severely practical. Wherever possible, the illustrations used are based upon the published figures of well-known companies, and all the conclusions reached are designed to be of concrete service to the wayfaring investor and his professional mentors.

Briefly, the book begins by asking who is the investor. It proceeds to analyse the merits, as investment media, of Debentures, Preference shares and Ordinary shares. A technique for measuring the value of equity shares is suggested, which substitutes an analysis of long-term factors for the more or less inspired opportunism which usually costs the investor dear in both good times and bad. Company accounts are dealt with from the point of view of those who read them rather than those who compose them. The section dealing with the duties of directors is concerned less with legal questions than with the real nature of the duties of foremen in the profits factory, and the extent to which those duties are adequately and faithfully performed. The chapter on the Stock Exchange takes for granted a knowledge of terminology and methods, such as can be obtained from many excellent textbooks, and concerns itself with the question of whether the "House" provides optimum facilities as a security transfer market at the least possible cost.

The author is indebted to *The Financial News* for permission to republish matter which first saw the light in its columns, and to many friends in the City of London who found time, in a critical period in the financial affairs of the nation, to discuss the eternal verities of investment. It is, perhaps, needless to add that the writer is unconnected with any financial group.

H. P.

LONDON, E.C.4.
July, 1932.

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CHAPTER I

WHO IS THE INVESTOR?

ABSENCE of general knowledge as to identity of "average investor"—A sample investigation of ten large company registers—Wide distribution of holdings: advantages and disadvantages—Size of average holdings—Distribution of holdings of various amounts—Overwhelming numerical predominance of small investors—Large holders—Effective control without voting control—Conclusions.

IT is appropriate that a book on investment should begin with the question: Who is the Investor? Writers on subjects like big game, income-tax, and film stars, have the inestimable advantage that everybody knows what they are talking about. Those who write concerning, for, or at the investor have a more unenviable task. No one really knows precisely who the investor is. But everybody takes him for granted, which is an assumption as unfounded and unfortunate as that, say, of taking Woman for granted.

As the investor is the owner of British industry, and the ultimate recipient of its earnings, a clear knowledge of who and what he is, is a *desideratum* for all who wish to tax, protect, "educate" or organize him, or to make any contact with him whatsoever. Such knowledge is equally essential for the State, which desires to know how a proposed Budget expedient may affect future revenue; for the Stock Exchange Committee, debating (possibly) whether or not to endeavour to reach a larger circle of investors by advertising; for the stockbroker, who is not averse to enlarging his list of respectable clients; for the legislator, the company promoter, the issuing house, and the financial writer.

When one talks of "the investor," does one refer to the Bank of England, the joint-stock banks, the insurance

companies, investment trusts, limited companies and firms, trade unions, charitable organizations, the holder of 20,000 Courtaulds shares, the holder of 100 Courtaulds shares, the purchaser of a National Savings Certificate, the savings bank depositor (who makes and unmakes Governments in the polling booth), the capitalist, the worker, or any one of a hundred possible types? If a capitalist is one who owns capital, all these are capitalists, but their composition is so varied that what is medicine for some may be poison for others.

Statisticians, who are accustomed to deal with large and complex groups, usually endeavour, as a first step, to calculate "averages." It would be distinctly helpful if everyone concerned with investment possessed a working idea, at least, of the "average" investor—the investor in the street. Is he a Big Man or a Small Man? Is he the stout, frock-coated person habitually portrayed as Capital's prototype in political cartoons, or the gullible, semi-literate infant whom many company Chairmen appear to address in their annual speeches?

That no one seems really to know the answer may be attributed not to absence, but to over-abundance, of data. The material for a thorough-going investigation lies in the cellars of Somerset House, London, where a record is kept of the name and holding of every shareholder in every limited company registered in England. A register of Scottish company information, similarly, is kept in Edinburgh. One of the privileges of citizenship is the right to search the company records of Somerset House or Edinburgh for a nominal fee.

An unpleasant surprise, however, awaits the inquirer who pays his shilling, fills up a form, and demands a sight, say, of the files of Imperial Chemical Industries, Limited. Like Aladdin, he will be overwhelmed by the generosity of Allah, as the Slaves of the Lamp come up from the cellars, staggering

under the weight of one enormous volume after another. Imperial Chemical Industries has nearly 125,000 Ordinary shareholders alone. The reason one knows so little about them is that so many potential investigators, over-awed by the towering physical bulk of the records, have reflected that life is short, put on their hats and departed. This reluctance is unfortunate, because it is unnecessary. Human ingenuity has discovered many short-cuts by means of which reliable information can be obtained of the largest bodies of phenomena. Up to the present, however, these methods have been applied to problems of capital ownership only in scattered fashion, by special inquirers whose discoveries have seldom had wide publicity.

The application of such methods involves the expenditure of a certain amount of time and trouble. The modern State is well-equipped to conduct investigations on these lines. The State deems it indispensable to carry out regular population censuses, which tell the world a great deal regarding the numbers, age, and housing of those who use capital, in different industries. It is not, apparently, convinced of the necessity of compiling and publishing systematic information about those who own capital. Some day this omission will be remedied. In the meantime, as an example of what may be done in this direction, the author proposes to discuss a number of statistics relating to the ownership of the Ordinary capital of a number of the largest British industrial companies.[1]

It is a simple matter, given a company's official file, to ascertain the number of its shareholders, and, by dividing this figure into its total paid-up capital, to calculate the arithmetical *average holding* of its investors. There is a certain duplication of names in every list, but not on a sufficient scale to have more than a slight effect on the result.

[1] The figures are given by the courtesy of *The Financial News*, with whose assistance they were compiled.

The following, for example, shows the paid-up Ordinary capital, number of shareholders, and average shareholding of ten leading British industrial concerns, whose shares are among the leaders of the Industrial market and enjoy the utmost possible "freedom" of dealing.

Company	Nature of Shares	Amount of Paid-up Capital	Approx. Number of Shareholders	Average Shareholding
		£		£
Imperial Chemical	Ordinary	43,589,538	124,690	350
Imperial Tobacco	Ordinary	37,492,625	94,690	396
Courtaulds	Ordinary	24,000,000	59,940	400
Dunlop	Ordinary	7,851,046[1]	52,620	149[1]
J. & P. Coats	Ordinary	14,750,000	49,570	297
Unilever, Ltd.	Ordinary	11,318,750	19,420	583
Fine Spinners	Ordinary	4,410,000	17,160	257
Cunard	Ordinary	5,570,241	13,860	402
Staveley Coal	Shares	3,385,356	6,290	538
Watney, Combe, Reid	Deferred Ord. Stock	3,185,410	4,520	705

[1] £1 shares reduced to 6s. 8d. and subsequently consolidated into stock.

Two features of the table call for critical comment—the large size of the average body of proprietors, and the smallness of the average holding.

Clearly, if the object of the Companies Acts, which made limited liability and corporate powers available for the asking, was to democratize the ownership of industrial capital, the statutes have done it very well. Their success, is an achievement, the importance of which it would be difficult to overrate. The great inventions of the last century-and-a-half demanded the accumulation of unheard-of hoards of capital. That the standard of living of the average worker was four times as high in 1920 as in 1820 must be attributed, in no small part, to nation-wide co-operation in investment, and in this respect the Companies Acts deserve a pedestal of equal altitude with the steam engine, the electric motor, the internal combustion engine, and other deities of the Age of Gold.

To-day, however, it is becoming more and more difficult to be certain whether wide diffusion of capital ownership is

a blessing or a curse. As industrial units grow more gargantuan, their owners become increasingly scattered, heterogeneous, and inarticulate. No man feels especially well disposed to another who happens merely to hold shares in the same company. The bond of union is insufficient to justify an invitation to dinner, and far too slender to encourage, say, an introduction to one's wife.

In short, the "*argumentum ad pocketum*," which is one of the most powerful safeguards of modern civilization, is progressively weakened as the number of a company's shareholders increases. How, for instance, do the proprietors make their will effective? The Law replies—in the manner of the Greek demos, by attending regular meetings, whose decisions have absolute force so far as the company is concerned.

The secretary of every company, in fact, sends out reports once every year, inviting each voting shareholder to attend a general meeting. What would happen if all the proprietors accepted the invitation? A glance at the table will suggest that the 6,290 shareholders of Staveley Coal might be crammed into the Albert Hall. A reasonably large football ground, however, would scarcely accommodate in comfort the 49,570 shareholders of J. & P. Coats, the 52,620 of Dunlop, or the 59,940 of Courtaulds. The Imperial Tobacco Company's 94,690 proprietors might just be squeezed in at Wembley—presumably with the big shareholders in the grand stands and holders of small amounts *en plein air* in the two-shilling enclosures. But where could the 124,690 Ordinary shareholders of Imperial Chemical Industries be accommodated? And how, under such conditions, could intricate questions of company finance be adequately debated?

The truth is that the system laid down by law continues to function only because the great majority of shareholders are prevented by conditions of residence, etc., from attending

annual meetings, or are insufficiently interested to attend. In all but a few exceptional cases, their only alternatives are to do nothing, or to vote for the directors before they have heard the Chairman's speech. If control of company affairs is to be really democratic and not oligarchic, it is not sufficient merely to utter pious platitudes about shareholders taking a greater interest in their businesses. New machinery is indispensable for making the will of huge armies of shareholders really effective.

The average shareholding shown above varies approximately from £250 to £700 (omitting the written-down shares of Dunlop). These figures may serve as a corrective of the idea that the proprietors of British industry are necessarily rich men. Without further inquiry, however, the utility of the statistics is limited. Apart from the fact that wise investors "spread" their holdings over many companies, an average of £300 will result if 50 per cent of shareholders each hold £299 and 50 per cent hold £301, or if 95 per cent hold £50 each and 5 per cent hold £5,050. Arithmetical averages have other defects. It is theoretically possible for not a single proprietor to hold the "average" number of shares. The position of the average, again, may be moved very considerably by differences in a few large holdings.

Any attempt to shift the inquiry from non-human averages to numbers of living shareholders comes up against the difficulty that, as the proprietors of large companies are many thousands strong, an exhaustive examination may be feasible for a Government Department or a Royal Commission, but is quite impracticable for a private inquirer. There is, however, a way out of this difficulty. All brokers and merchants are familiar with the process of judging bulk by sample. Tea-tasters form a reliable judgment of a consignment by testing a small quantity, and capital-tasters may use the same method. In other words, one can obtain

remarkably accurate information as to the distribution of share ownership by examining, not an entire file, but a number of typical entries. Two conditions must be satisfied. First, the selection must be made without bias or preconceived ideas of any kind. Secondly, the samples must be sufficiently numerous to allow full play to the so-called "law of averages."

Accordingly, from the Somerset House files of each of the ten companies given in the previous table an analysis was made of the holdings of the first, eleventh, twenty-first, . . . Ordinary shareholders to the end of the list. Thus the number of sample entries obtained ranged from 452 in the case of Watney, Combe, Reid to 12,469 in that of Imperial Chemical Industries. The results were then grouped according to the size of individual holdings—1 to 9 shares, 10 to 99 shares, and so on. The resulting table, given on page 8, shows the manner in which the Ordinary capital of ten of the most active British companies was distributed among the proprietors concerned.

The figures take one close to the heart of the problem "Who is the Investor?" and throw a flood of light on many investment questions.

A few of their implications may be discussed. In the average British company, which is the largest group of Ordinary shareholders? The answer is: Holders of fewer than 100 shares. Taking the average of the ten companies, such holders are shown to include over 40 per cent, by number, of the total proprietors. Which is the next largest group? Holders of 100 to 199 shares. What proportion of total shareholders have holdings of 5,000 shares or more? Less than 1 per cent.

Putting the same conclusions in a slightly different way, one may say that, as regards the Ordinary shares of an average British company, with a large capital and an active market for its shares, (1) approximately 40 per cent of the

Distribution of Capital Ownership of British Companies

	Nature of Shares	Denomination	Total Holders of: 1 to 9 Shares	10 to 99 Shares	100 to 199 Shares	200 to 499 Shares	500 to 999 Shares	1 000 to 4,999 Shares	5,000 Shares or Over	Total Shareholders
A—Numbers of Shareholders.										
Imperial Chemical	Ordinary	£1	6,810	43,530	29,960	27,560	10,510	5,650	670	124,690
Imperial Tobacco	Ordinary	£1	1,080	43,760	25,020	15,550	5,490	3,240	550	94,690
Courtaulds	Ordinary	£1	560	25,360	15,440	11,940	3,280	2,990	370	59,940
Dunlop Rubber	Ordinary	6s. 8d.[1]	620	14,330	14,470	13,520	5,120	4,050	510	52,620
J. & P. Coats	Ordinary	£1	550	23,420	13,470	7,970	2,430	1,500	230	49,570
Unilever, Ltd.	Ordinary	£1	250	9,100	5,300	3,180	920	580	90	19,420
Fine Spinners	Ordinary	£1	880	6,410	4,750	3,350	1,020	690	60	17,160
Cunard	Ordinary	£1	50	3,780	4,280	3,580	1,310	720	140	13,860
Staveley Coal	Shares	£1	60	1,690	1,420	1,650	810	610	50	6,290
Watney, Combe, Reid	Def. Ord.	£1[2]	10	1,120	1,310	1,190	420	360	110	4,520
Total—10 Companies[3]	—	—	10,870	172,500	115,420	89,490	31,310	20,390	2,780	442,760
B—Percentages of Total Shareholders.			%	%	%	%	%	%	%	%
Imperial Chemical	*Ordinary*	*£1*	*5·5*	*34·9*	*24·1*	*22·1*	*8·4*	*4·5*	*0·5*	*100·0*
Imperial Tobacco	*Ordinary*	*£1*	*1·1*	*46·3*	*26·4*	*16·4*	*5·8*	*3·4*	*0·6*	*100·0*
Courtaulds	*Ordinary*	*£1*	*0·9*	*42·3*	*25·8*	*19·9*	*5 5*	*5·0*	*0·6*	*100·0*
Dunlop Rubber	*Ordinary*	*6s. 8d.*	*1·2*	*27·2*	*27·5*	*25·7*	*9·7*	*7·7*	*1·0*	*100·0*
J. & P. Coats	*Ordinary*	*£1*	*1·1*	*47·2*	*27·2*	*16·1*	*4·9*	*3·0*	*0·5*	*100·0*
Unilever, Ltd.	*Ordinary*	*£1*	*1·3*	*46·8*	*27·3*	*16·4*	*4·7*	*3·0*	*0·5*	*100·0*
Fine Spinners	*Ordinary*	*£1*	*5·1*	*37·3*	*27·7*	*19·5*	*6 0*	*4·0*	*0·4*	*100·0*
Cunard	*Ordinary*	*£1*	*0·4*	*27·3*	*30·9*	*25·8*	*9·4*	*5·2*	*1·0*	*100·0*
Staveley Coal	*Shares*	*£1*	*0·9*	*26·9*	*22·6*	*26·2*	*12·9*	*9·7*	*0·8*	*100 0*
Watney, Combe, Reid	*Def. Ord*	*£1*[2]	*0·2*	*24·8*	*29·0*	*26·3*	*9·3*	*8·0*	*2·4*	*100·0*
Total—10 Companies[3]	—	—	*2·5*	*38·9*	*26·1*	*20·2*	*7·1*	*4·6*	*0 6*	*100·0*

[1] Subsequently converted into stock. [2] £1 units of stock. [3] Total capital involved £155,552,966.

total proprietors each hold fewer than 100 shares; (2) two-thirds of the total proprietors each hold fewer than 200 shares; (3) nearly 90 per cent of the total shareholders own fewer than 500 shares each; (4) only about 5 per cent of the proprietors hold over 1000 shares each.

Though the proportions vary somewhat as between different companies, one general conclusion applies to all. The overwhelming majority of holders of British Industrial shares are small holders. Doubtless, a few very large holders may endeavour to disguise the extent of their ownership by splitting up their blocks of shares. That such a tendency can seriously qualify the conclusions drawn from the table is improbable. A man would be a fool to go to great trouble to split his holding in order to conceal it, when he could achieve his object much more efficaciously by having his shares registered in the name of some "nominee" concern. Further, it is more expensive, proportionately, to acquire a small than a large holding.

Despite the well-known tendency of investors to spread their holdings over different companies, the figures in the table strongly suggest that the majority of investors are persons of moderate means. A wealthy man or an institution with £250,000 to invest will not go to the trouble of finding 1,250 separate companies and putting £200 in each. There is a limit to "spreading," and for very wealthy investors this limit is reached in most cases at an average investment per company appreciably higher than that of the majority of shareholders, as revealed by the above table. The smallness of the "normal" shareholding in British companies is much more likely to result from the efforts of investors of moderate means to spread a modest aggregate total of resources over as many companies as possible.

The large holdings, however, call for further examination. How far do they carry financial control? In the absence of clear evidence on this point, it may be urged that it matters

little that the overwhelming majority of shareholders are small holders, if a few large holders, controlling more than 50 per cent of the issued shares of any company, are able to outvote their fellow shareholders at annual meetings. To obtain an insight into the matter, a supplementary search was made of the files of the ten companies dealt with in the tables above. Particulars were extracted of every holding of more than 50,000 shares. The results are shown in the next table. Special interest attaches to the last three columns, in which the total shares in the hands of large holders are compared with the total in issue by each company.

The results may surprise those investors who believe that, in the twentieth century, it is necessary to obtain a 50·1 per cent holding to secure effective control of a company's affairs. Actually, there is only one company—Unilever, Limited—out of the ten shown in the table, whose large shareholdings account for more than half its Ordinary capital. In this case, special financial arrangements obtain, and are a matter of common knowledge. Among the other nine companies, there is not a single instance in which large holders, together, control as much as one-third of the capital. In six cases, such holdings do not account for as much as one-fifth of the whole.

That control of particular companies is known, nevertheless, to be associated with particular interests must be related to the scattered ownership of British capital. This tends to produce a certain inertia, by virtue of which governing interests may allow their shares, if they wish, to run down to the bare directorial qualification. The satisfactory results obtained for years past by the majority of the companies in the table suggest that this freedom from interference may have its beneficial side. Shareholders' interests, indeed, may be well served by giving a shrewd, skilful and hard-working executive its head. In less able

SHAREHOLDINGS OF 50,000 OR OVER

Company and Capital	50,000 to (under) 100,000 Shares		100,000 to (under) 1,000,000 Shares		1,000,000 Shares or over		Total Shares in Large Holdings (50,000 or over)	Total Shares Issued	*Percentage of Total Capital in Hands of Large Holders*
	No. of Holders	Total Shares Held	No. of Holders	Total Shares Held	No. of Holders	Total Shares Held			
									%
Imperial Chemical (Ord. £1)	2	140,065	14	1,877,333	1	2,308,875	4,326,273	43,589,538	*9·9*
Imperial Tobacco (Ord. £1)	34	2,164,592	35	8,101,087	1	1,488,492	11,754,171	37,492,625	*31·4*
Courtaulds (Ord. £1)	22	1,473,916	20	5,847,517	—	—	7,321,433	24,000,000	*30·5*
Dunlop (Ord. 6s. 8d.)	15	968,804	5	676,150	1	1,050,000	2,694,954	23,553,139	*11·4*
J. & P. Coats (Ord. £1)	6	453,178	11	1,964,611	—	—	2,417,789	14,750,000	*16·4*
Unilever, Ltd. (Ord. £1)	2	106,150	4	515,891	2	5,850,000	6,472,041	11,318,750	*57·2*
Fine Spinners (Ord. £1)	1	60,000	1	138,000	—	—	198,000	4,410,000	*4·5*
Cunard (Ord. £1)	7	516,504	—	—	—	—	516,504	5,570,241	*9·3*
Staveley Coal (Shares £1)	3	182,885	1	172,457	—	—	355,342	3,385,356	*10·5*
Watney, Combe, Reid (Defd. £1 units)	1	90,000	4	632,117	—	—	722,117	3,185,410	*22·7*

and less scrupulous hands, however, the divorce of control from ownership offers formidable possibilities of abuse.

Some large contracting firms have a partner who, in the informal privacy of the *sanctum sanctorum*, is known as the "barman." To him falls the important duty of entertaining potential clients in places where refreshment is sold under conditions of extreme comfort. Similarly, if control of a company is desired, it is unnecessary, in many cases, to embark on the arduous and costly task of accumulating a voting majority by share purchases in the market. What are grill-rooms, country seats, and shooting-boxes for?

The position of controlling interests, in some respects, resembles that of bankers. The latter, normally, keep a cash reserve of only a fraction of their total demand liabilities. The banking system functions on the sound assumption that, in practice, the great majority of depositors will never ask for their money back at the same time. Similarly, controlling interests may have only a minority shareholding interest in the companies under their effective rule. They know quite well that the rank-and-file of shareholders will attempt to exercise their voting power only in times of crisis.

It is now possible to summarize the main conclusions of this inquiry into the ownership of British capital. They form an appropriate background for the discussion, in subsequent chapters, of detailed investment problems. The object has been to discover what kind of man, economically speaking, the British investor really is. Adopting the views expressedon the figures, at the author's request, by a leading financial newspaper, one may describe them as having shown that, in the case of ten representative companies, of the total number of Ordinary shareholders no less than 87·7 per cent held less than 500 shares, and only 5·2 per cent held more than a thousand. Another part of the investigation showed that that 5·2 per cent of the total number of shareholders usually included the holders of some very

large blocks indeed; but only in the case of one company (to which special reasons applied) did the total of large holdings (over £50,000) exceed one-third of the capital. The research thus proves with finality that on normal voting power, where the decision is by show of hands, the control of British industry is overwhelmingly with the investor of small sums, and that even on a poll the small investors, in the aggregate, can count more than two votes to the large investors' one.

In practice, voting power on paper is very different from voting power in the general meeting of the company; the simple factor of space limits the control which numbers give to the investor. There might perhaps be an opening for some institution which would represent the votes of the majority of shareholders at general meetings, and employ those votes in the interests of their proprietors. Such an institution, however, even if it were started, would probably die of neglect. Directors on the whole have the confidence of their shareholders, and deserve it. If a shareholder mistrusts his directors he will usually cut his loss and sell out. That, and the smallness of the average holding, are the root cause of control and ownership being so widely separated in present-day industry.

Whatever may be the relation of control and ownership, however, the sources of British industry's capital are of practical and immediate importance. It emerges very clearly from the statistics discussed in this chapter that it is not the banks and great corporate investors which control the supply of industry's capital, but the small investor, who probably knows very little about industries other than his own. Ordinary shares, of course, are not the only form which industrial capital may take, and a census of Ordinary share registers may not give an exact picture of the springs of capital. But, in practice, it is unlikely that a census of Preference shareholdings would produce a very different

result; and in any case Ordinary shares are by far the most important form of capital in industry. The ten sample companies, in this case, had a total Ordinary, Preference and Debenture capital of £253,553,000, of which about 8 per cent was in Debentures and mortgages, 26 per cent. in Preference, and 66 per cent in Ordinary. That may be taken as a fair example of capitalization in industrial concerns as a whole, though a greater share of Debentures is appropriate to some enterprises, and nothing but Ordinary shares to others.

The distribution of capital ownership is a matter of prime importance, not only to company organizers and directors, stockbrokers and capital issuing-houses, but to "higher quarters." It has been estimated, for example, that the re-organization of certain of Great Britain's "key" export industries, which have been impoverished by financial difficulties since the Great War, may call for the provision of many million pounds of new capital. The bulk of the money must come ultimately from the scattered investors of hundred-pound holdings. The problem of industrial reconstruction is thus not only one of technicalities and high finance, but, if the reconstruction is to be solidly based, one of liaison between the suppliers and the users of industrial capital. The considerations disclosed in this chapter suggest that the great financial institutions which have undertaken the supervision of industry's rebuilding may be required to expend considerable thought upon the question of attracting the financial suffrage of the small, even more than that of the large, investor.

CHAPTER II

DEBENTURES

LEGAL distinction between debentures and shares—Can it be sustained on first principles?—Relation between debentures and "fixed" capital—Examples from British industry—Market price of debentures—Influence of fluctuations in trading activity—"Money risk" and "industrial risk"—Characteristics of good and bad debentures respectively—Foreclosure rights of debenture holders—Their limited utility—Earning power the only sound security for debentures.

A PRELIMINARY inquiry into the ownership of British industrial capital having thrown some light on the question "Who is the Investor?" the road is clear for a critical analysis of the merits of various investments. Every textbook on finance distinguishes "fixed-interest" securities from "ordinary" or "equity" securities, and further sub-divides the former group into Debentures and Preference shares, of various classes. It is proposed to consider, in succeeding pages, the nature of the investment "appeal" of industrial Debentures, and Preference and Ordinary shares, in turn.

The difference in genus between "fixed-interest" and "equity" securities is readily apprehended. The first entitle the holder to his pound of flesh, when the meat is there. The second make the world his oyster—in theory, at least. The distinction between the Debenture and Preference sub-groups, however, is much more subtle. Most writers declare, and many readers believe, that the two differ not only in degree, but in kind. Preference shares, the argument runs, are entitled to dividend only when profits are available and directors have resolved to divide them. *Legally*, Debentures, however, are not part of a given company's *capital* but of its *funded debt*. Debenture-holders, being creditors and not proprietors, are entitled to payment of their full rate of interest whether profits are available or not. The liability to remit interest on Debentures is created automatically

with the passage of an agreed interval of time, and directors have no discretional powers in the matter.

This is a correct statement of the legal position. Can one legitimately argue, therefore, with the writers of most text-books that the *security* of a Debenture, from the investor's point of view, is unique, differing radically, in ultimate analysis, from the security of a Preference share?

The Debenture-holder, it is assumed, is a happy being, who is totally unconcerned with fluctuations in earning power. For Preference and Ordinary shareholders the hard rule is: No profits, no dividends. The Debenture-holder, however, if he receives no interest, has usually the right to foreclose, sell the company's assets, and recover his principal. To put the matter crudely, if a company makes profits, he receives his interest; if it ceases to make them, he gets his money back.

The consequences of the universal acceptance of this legal dogma have been, first, that a halo of sacrosanctity has surrounded the Debenture, and, secondly, that companies and industries with a large proportion of "fixed" capital assets (which can readily be mortgaged) have obtained much cheap capital by Debenture issues.

Group	Number of Companies	Total Deb. Capital	Total Pref. and Ord. Capital	*Amount of Debentures per £100 Pref. and Ord. Capital*	Rate of Interest and Dividend Paid in a Recent Year		
					Interest on Deb	Div. on Pref	Div. on Ord.
Groups with Large Fixed Assets—		(£000)	(£000)	£	%	%	%
Electric Power	44	38,076	[redacted]	*55·4*	5·1	5·6	7·2
Shipping	42	22,765		*38·1*	5·0	5·5	4·5
Breweries	108	54,081		*45·4*	4·8	4·1	16·6
Waterworks	29	6,925		*43·1*	4·7	5·4	6·9
Gas	52	24,876		*35·8*	4·3	4·1	6·3
Companies with Small Proportion of Fixed Assets—							
Shops and Stores	69	16,243	78,740	*20·6*	5·3	6·5	13·5
Oil	23	9,830	108,536	*9·1*	5·3	6·6	12·7
Tea	106	1,087	20,470	*5·3*	7·6	5·0	10·6
[1]Miscellaneous	635	90,495	789,796	*11·5*	5·5	6·5	10·9

[1] A general sample of British industry, including merchanting activities.

Obviously, the proportion of total earning assets represented by land, buildings and plant is higher in the case of concerns like breweries or waterworks than in that of, say, merchanting houses or retail stores. Any investigator who has the time to plough through a work like *The Stock Exchange Official Intelligence* can put the matter to the test. The table, shown on page 16, for instance, is based on data covering a number of representative companies.

The table shows that British companies in the past have been able to raise Debentures with an average interest rate well under 6 per cent. Naturally, therefore, there has been a tendency in some cases to issue Debentures up to the hilt —the effective limit being, in most cases, the amount of fixed assets which could be pledged. "Current" assets have frequently been pledged also, by way of floating charge, but for various reasons this form of security is less popular.

But is the Debenture-holder, in the last resort, really safeguarded against the decadence of a company or an industry? Suppose that the true economic valuation of capital assets is not permanently "fixed," but is high when profits are high and low when profits have fallen. It follows that the Debenture-holder's security may be worth least when he forecloses—since then, *ex hypothesi*, profits will be *nil*. In short, may not earning power, in the last resort, be the only real security for Debentures, as for Preference and Ordinary shares?

This question deserves detailed examination. It may be advisable to consider the position of a Debenture, first, in periods of good trade and high profits, and, second, in bad times.

When industry is active, a company of average efficiency and average capitalization may be capable of earning an "over-all" rate of, say, 10 per cent on its total issued capital (with certain exceptions, such as British railways). To take an imaginary example, suppose that a concern has

a capital of £1,000,000 made up as to £200,000 of 6 per cent Debenture stock, £300,000 of 7 per cent Preference stock, and £500,000 of Ordinary stock. Profits of £100,000 (10 per cent) will cover its Debenture interest (£12,000) over eight times. Given such a cover, backed by a charge on fixed assets valued at, say, £750,000, the "industrial risk" on the Debentures (i.e. the investor's fear of present or future failure of the company to meet its obligations) will be regarded as practically *nil*. The market price of the Debenture will then be determined by the answer to the question: "How much is a certain income of £6 per £100, nominal, worth to the average investor?" (In other words, the market price will be governed by the prevailing level of long-term interest rates.)

As a general rule, the best indicator of short-term interest rates is Bank rate, and the best index of long-term rates is the yield on British Government stocks. Actually, the two are intimately connected. When Bank rate is high, floating resources can be put on deposit at the banks to give a relatively handsome yield without the payment of stamp duties or commissions, or the running of market risks. When Bank rate is low and deposit rates unattractive, much more money will come for "safe" investment to the Gilt-edged market. Speaking very broadly, the rule is: Dearer money, lower Gilt-edged prices; cheaper money, higher Gilt-edged quotations.

But epochs of brisk trade are generally accompanied by "dear money," since the demand of industrialists for financial accommodation is then above the average. The paradoxical result often follows that a Debenture-holder who wishes to realize his stock may obtain least for it, when its "security," in theory, is at a maximum. This tendency is intensified by the psychological effects of rising profits on the multitude. Since Ordinary shareholders alone receive the fruits of higher industrial earnings in hard cash, the public (which,

when markets are active, seldom sees any reason why earnings should not go on increasing for ever) regards "fixity" as a disqualification in a boom. It therefore tends to transfer at least part of its resources from fixed-interest to equity stocks.

If the imaginary £1,000,000 company mentioned above, which earned £100,000 (10 per cent) in a good year, were to proceed to pay out the whole, it would distribute its earnings as follows—

TOTAL PROFITS £100,000

	Interest and Dividend
	£
£200,000 6% Debenture Stock . . .	12,000
£300,000 7% Preference Stock . . .	21,000
£500,000 Ordinary Stock (Dividend 13·4%) .	67,000
	£100,000

If the investor of the time demanded, on the average, a 7½ per cent yield on a good equity stock, the market price of 100 Ordinary would be 179. If, concurrently, Bank rate were 3½ per cent and sound Debentures were being bought in the market to yield, say, 5¼ per cent, the company's Debenture stock would be quoted at about 114.

Let it be imagined that, in due course, industry and the Stock Exchange showed symptoms of feverish "prosperity," and the company, having considerably increased its trading activity, earned an "over-all" rate of 15 per cent on its capital. Its profits would then be divided as follows—

TOTAL PROFITS £150,000

	Interest and Dividend
	£
£200,000 6% Debenture Stock . . .	12,000
£300,000 7% Preference Stock . . .	21,000
£500,000 Ordinary Stock (Dividend 23·4%) .	117,000
	£150,000

The investing public, delighted and deeply impressed by the rise in Ordinary dividend from 13·4 per cent to 23·4 per cent (which would be paralleled by the experience of many other companies), may now be presumed to be willing to pay something for the prospect of further rises in the future. Consequently, it may regard 5 per cent, instead of $7\frac{1}{2}$ per cent, as an appropriate present yield basis for Ordinary shares in general. The result is a rise in the company's Ordinary stock quotation (previously 179) to 468.

Bank rate, however, has reached a "boom" level of 6 per cent; part of the rise in Ordinaries has been financed by sales of fixed-interest stocks, and Debentures in general are now bought on a yield basis of as much as $6\frac{1}{2}$ per cent. The company's Debenture stock will therefore decline from 114 to a market price of about $92\frac{1}{2}$.

The longer high profits last, the greater the liability of the Debenture-holder to capital depreciation, not *in spite of* the fact that industry is prosperous, but *because* it is prosperous. This is the theory of the matter. To sum up, it may be suggested that while periods of good trade improve the "backing" of industrial Debentures, the high money rates normally associated with such epochs act as an effective brake on any incipient upward movement in market value. When trade turns downwards, the converse applies, low interest rates tending to raise the market price of Debentures. If industrial depression becomes extreme, however, the security market may be intimidated by the "industrial risk" which attaches to all securities whose service is dependent on the earnings of industry. Investors may become acutely anxious as to the entire financial position of certain companies, and there may be, consequently, in any severe depression, a "dead point" at which Debentures are almost unsaleable, because the public has overhastily included them in a general condemnation of all industrial securities. This abnormal condition, however, is

never of long duration. Sooner or later, the public proceeds to separate the industrial sheep from the goats, and to value individual Debentures, like other securities, approximately on their merits. It is then that the difference between good and bad Debentures becomes painfully apparent.

What are the hall-marks of a "good" Debenture? The answer may be given by reference to a number of examples. Over a recent period of five years, the average return on the *total* capital (Debenture, Preference and Ordinary) of over 2,000 British companies declined from 10·50 per cent to 7·98 per cent. During the same quinquennium, however, the average yield, at market prices, of ten industrial Debentures, of high reputation among investors, fluctuated only between 5·23 per centand 5·37 per cent, and stood at the same level—5·28 per cent—in the last as in the first year. In other words, the price of these ten "good" Debentures remained practically constant while the total earnings of British industry declined by 24 per cent. That the public instinct was not altogether at fault is suggested by the table given below, which shows the extent to which the interest on each of the ten Debentures was covered by annual earnings during the last year of the quinquennium, when industry was depressed and total earnings reached a low level—

Company and Stock	Total Earnings before Deb Interest	Amount Required for Deb. Interest	*Percentage of total Earnings taken by Deb. Interest*
	£	£	%
Great Western 4% Deb.	7,136,634	1,548,692[1]	*21·7*
P. & O. 3½% Deb.	1,115,004	52,065	*4·7*
Bass 5½% Red. Deb.	745,715	206,746	*27·7*
Associated Electrical 4% Mort. Deb.	306,772	41.454	*13·5*
Associated Portland Cement 4½% Red. Deb.	685,300	75,158	*11·0*
John Barker 4½% Irred. Deb.	444,640	6,750	*1·5*
John Dickinson 4½% 1st Mort. Deb.	203,924	20,273	*9·9*
J. Lyons 4% 1st Mort. Deb.	964,634	12,000	*1·2*
Savoy Hotel 4% 1st Mort. Perpet. Deb.	187,905	18,000	*9·6*
Wm. Cory 4% 1st Mort. Deb.	663,596	28,000	*4·2*

[1] Amount required for *all* Debenture interest, since Debentures of Great Western rank *pari passu*.

Though the figures relate to a year of industrial depression, it is noteworthy that in none of the ten instances shown above was more than the first 28 per cent of the year's earnings required for Debenture interest. In six cases, interest called for less than 10 per cent of the total earnings. On the average, only 16 per cent of the year's earnings was required. Debenture-holders had the assurance that the tide of depression might rise, so to speak, another 84 feet without lapping against the foundations of their edifice, though a rise of, say, 25 feet might have covered the Ordinary shareholders' one-storey bungalow, and a rise of 50 feet might have made even the Preference shareholders' villa temporarily uninhabitable.

The real "security" for a Debenture, indeed, may be regarded as dependent on two factors—distance from the water's edge, and the behaviour of the tides. Neap tides, in periods of "normal" industrial activity, worry Debenture-holders little, since they neither come in nor go out very far. Spring tides, however, associated with industrial booms and slumps, are a different matter, and no Debenture can be regarded as really sound unless it is immune even from the suspicion of being touched by the highest tide. Some rivers and creeks are known to have wider tidal variations than others. Similarly, certain industries are susceptible to wider fluctuations of prosperity than other trades. The greater the liability of a trade or company to extremes of earnings, the less advantageous a field it offers for the issue of Debentures. Earnings stability, in short, and not the proportion of "fixed" to "floating" capital, should be the criterion as to the *optimum* amount of Debentures issued.

Unfortunately, as many investors have learned to their cost, sound Debentures, whose interest is "covered" many times over by industrial earnings even in bad times, do not comprise the whole of the Debenture stocks issued and dealt in. Many others appear to be well-secured when trade is

booming, but their margin of safety becomes miserably lean, or disappears altogether, when industry encounters adverse times. In such an event, what is the probable position of holders?

If earnings cover on any Debenture is seriously reduced, the operation of the "industrial risk" factor will cause a fall in the market value of that security, whatever the prevailing level of general interest rates. If the margin is entirely swallowed up by a recession in profits, the "nuisance value" of a Debenture will immediately come into play. Directors seldom hesitate to tell Preference shareholders to whistle for their dividends when no profits are available. They must, however, be much more *soople* to Debenture-holders, who, receiving no interest, have the right to apply to the Court for a receiver forthwith. The receiver may turn out the directors, neck and crop, and bring the business, as a provider of directorial fees and salaries, to an untimely end. The company, therefore, will probably strain every nerve to pay Debenture-holders their interest, once, twice and thrice. It may even deplete its liquid capital, or endeavour to negotiate a bank loan for the purpose. If the company is suffering merely from "cyclical" depression, or has temporarily struck a bad patch, in due course it will rehabilitate itself. Interest will then be paid once more out of profits, and the "charge" which the Debenture-holders possess over its assets will have served to protect their income against the effects of an extreme fluctuation in earnings.

Suppose, however, that the depression is not temporary, but the company, in fact, has been gripped by a mortal disease. British company history is strewn with the dead bones of concerns, apparently stable and prosperous, which have come to grief in this way. The possible causes are legion. Some Darius Clayhanger, uncouth and aitchless, whose genius has raised a business from small beginnings,

may have died and left no successor. A successful small concern may have failed irretrievably after inflating itself by a big public issue of capital. A sound business may have joined an over-ballasted combine. A financier may have dug his teeth into a company, and sucked it dry. Its board-room may have been dominated by a megalomaniac. An old-established and highly profitable industry may have been rendered completely unprofitable by changes in knowledge, public taste, tariffs, or that ruthless slaughterer of the innocents whose name is Progress.

The heavy iron and steel industry of Great Britain, since the War, has been a monument to the mutability of industrial prosperity. Debenture-holders in some of the largest concerns have been confronted with the alternative of foreclosing or submitting to far-reaching changes in their status. What choice have they made? Here is an answer, in the cold language of official records.

Holders of £1,270,000 7½ per cent Debentures of Pearson and Knowles agreed to the conversion of their Debentures into income stock. Holders of £1,300,000 6 per cent Debentures of Partington Steel and Iron agreed to take income stock and Preference shares. Holders of £2,113,700 7½ per cent Debentures of Baldwins consented (after some opposition) to a scheme under which part of their holding was reduced in interest, part was exchanged for convertible, and part for non-convertible income Debentures. Bankers holding £4,871,986 of various Debenture stocks of Sir W. G. Armstrong, Whitworth & Co. agreed to take, instead, Ordinary shares entitled to a percentage of future surpluses. Holders of a further £1,036,014 of 4 per cent Mortgage Debenture stock exchanged a fixed for a floating charge; holders of £3,500,000 5½ per cent Secured Mortgage Debentures took income Debenture stock, together with shares in a new company; and holders of £2,592,000 6½ per cent Consolidated Debentures took income Debentures. First Debenture stockholders in Barrow Hæmatite Steel exchanged half their holding for Ordinary shares, and agreed, *pro tem*, to allow interest on the rest to be contingent on the earning of profits.

Other instances might be given, but these are sufficient to show that, in the recent past, many Debenture-holders, with millions of pounds of capital at stake, have preferred

to abandon rather than to enforce their rights. In time of trouble, these holders had but cold comfort from their professional advisers. The accountants informed them that their company's position, in practically every case, was much worse than appeared from previous reports which members of the accounting profession had certified. They showed, with a wealth of detail, how much capital had effectively gone to perdition, and how little the assets would probably realize on a forced sale. The solicitors declared that, as far as the legal position of the Debenture-holders was concerned, there was no possible doubt whatever that the trustees had the right to apply for a receiver, to administer something which no longer had any value.

Having painfully digested the advice of both sets of counsellors, Debenture-holders perceived that the only hope of avoiding disaster lay in keeping their companies going at all costs. This, in effect, meant the provision of new money from outside, which was incompatible with the appointment of a receiver.

The epitaph on the foreclosure right of a bad Debenture has a melancholy simplicity: *Capax imperii nisi imperasset* —effective until tried out. The popular view that holders of bad Debentures are protected against ultimate loss by their powers of foreclosure is a dangerous delusion. Experience teaches that, when large companies are in danger of foundering, Debenture-holders may find it more advantageous to forgo than to exercise their rights. Their position, indeed, is far more exposed than is generally realized, in the sense that their peculiar powers, which appear to be a source of strength, may themselves be a cause of weakness. For example, their power to demand the payment of interest, even though no profits have been earned, may be a safeguard of their income in a purely temporary trade depression, but when a company is going permanently downhill, the fact that Debenture-holders are, legally,

creditors and not proprietors may be a positive disadvantage to them.

Cancer, as every doctor knows, may be susceptible to early treatment, but becomes incurable when it reaches an advanced stage. Ordinary shareholders, having obtained information of a spectacular change of fortune, have votes with which to enforce their will—though they commonly make little effective use of them. The Debenture-holder, however, cannot interfere so long as the service of his security is maintained. He may see a business, year after year, approaching nearer the end of all things, and may even know that the paying out of his own interest is weakening its eventual powers of resistance. But his rights themselves frequently preclude his interference until, in far too many cases, nothing remains but the funeral.

When that evil day comes, Debenture-holders quickly learn that "capital" assets have no value apart from their earning power. A railway line running through profitless territory to a closed terminal is not worth the labour of digging up. A factory equipped to manufacture a product which nobody will buy is merely a warehouse for old iron, though its wheels may go round as smoothly as ever. Some progressive concerns, in "new" industries, such as electrical equipment manufacture, have scrapped machines, on occasion, which have never been used—because the development of knowledge and technique has made them obsolete in the few months between the placing of the order and the delivery of the machinery.

It matters little how much money may have been expended on profitless assets in the first place, though this is generally the basis of the balance-sheet figure on which Debenture-holders value their "fixed assets cover." All plant valuations include a large goodwill item from time to time, in the sense that, if earning power falls, the true plant figure declines in proportion. A receiver cannot get Debenture-holders their

money back by selling the ruins of a business. The best he can do is to "nurse" the enterprise into some sort of profit-making condition, if matters have not gone too far. This is the basis for the "going concern" valuation with which Debenture-holders are frequently confronted on condition that they refrain from forcing a break-up. In other words, they are assured that their rights may ultimately have *some* value, so long as they do not proceed to enforce them. The conclusion thus suggested might well be framed in scarlet letters and hung by every investor's bedside: THE ONLY SECURITY FOR DEBENTURES IS EARNING POWER.

We may now gather together the threads of the argument of this chapter, in which the Debenture has stood its trial on a charge, not exactly of false pretences, but of being not quite what it seems to be. The investor's attitude towards Debentures, in the present writer's opinion, should be governed by the following considerations.

First, every investor should include some of the best Debentures among the more solid stocks which serve as a foundation for his portfolio. Debenture-holders have the second bite (after the income-tax collector), at every year's industrial profits. So long as a national currency is secured against inflation, and populations require to be fed, clothed, and amused, company profits will be made, and the privilege of priority over other capital in the annual share-out must needs have *some* value.

There is a mistaken impression that Debentures have a *first* charge on profits. That prerogative, however, is reserved for the tax-gatherer, and for that reason British Government stocks (whose "security" is the first-fruit of the tax collector's endeavours) stand on a lower yield basis than the best Debentures.

Secondly, as the yield on good Debentures is normally less than one per cent. higher than the yield on Gilt-edged

stocks, only the best are a worth-while proposition at the price. The worst are dear at any price.

Thirdly, since no single industry, however well-run, is assured of complete immunity from long-term changes, which exalt the humble and bring the mighty low, the investor should spread his Debenture holdings, even of the strongest companies, over a considerable number of industries.

Fourthly, since the only permanent security for a Debenture is earning power, Debentures can best be regarded as pre-Preference shares, with special legal rights which may tide holders over temporary depressions in earnings, but which are most effective when they are unused. The only satisfactory criterion of the worth of a Debenture is its "earnings cover" over a period of years.

In the long run, this paradox is true: that the company whose Ordinary shares make the strongest appeal to the investor is the one which potential Debenture-holders should go to seek. The concern whose Ordinary shares are not worth buying can seldom issue a Debenture worth a conservative investor's attention.

Fifthly, the legal gulf separating the Debenture from the Preference share should be ignored by the investor. A First Preference stock in a company with no Debentures and a large and stable "earnings cover" is a far better thing than a Debenture charged on enormous balance-sheet "assets" in a second-rate concern. A bad Debenture should be shunned like the plague. Its spurious worth will probably result in its standing at an unwarrantedly high market price when the investor buys it. Its "nuisance value" will probably result in its receiving interest when no interest should be paid. When, finally, a default in interest payments allows holders, for the first time, to take joint action, the situation may be past retrieving except at heavy sacrifice.

CHAPTER III

PREFERENCE SHARES AND TRADE FLUCTUATIONS

DECLINING popularity of the Preference share—An expensive security—Absence of "nuisance value"—Falls between two stools—Stability a *sine qua non* for Preference shareholders—Available profits fall faster than turnover—Examples of industries with wide fluctuations—Disfranchisement of Preference shareholders—Public capital and private control.

THE main conditions determining the investment status of Debentures have been discussed at some length in the preceding chapter. It may now be appropriate to discover how the Preference share emerges from a critical analysis.

The War, which undermined so many reputations, has robbed the Preference share of much of its glory. In 1913, £1 9s. 4d. of Ordinary capital was issued for every £1 of Preference capital offered to the investor in the London market. Ten years after the War, in a period of great activity, the proportion was £3 13s. 6d. of Ordinary to every £1 of Preference.

The Preference share's critics declare that it involves serious disadvantages to both borrowers and investors. It has certainly been a costly instrument for borrowers since the War. Exclusive of participating rights, the average rate offered on Preference shares issued in London in the last five years of the nineteen-twenties was as much as 6·68 per cent.

From the investor's point of view, its defects are even more obvious. Preference shareholders, unlike Debentureholders, obtain their dividend only when earned profits are available and directors see fit to divide them. In return for a prior bite at profits, Preference shareholders surrender their equity in a company's future growth, and, in most cases, are disfranchised. However successful a company may be, its

Preference shares, without participating rights, cannot be expected to rise much above par.

Some critics go even further. A Debenture, they declare, is fundamentally a species of secured Preference share (since its real basis is continued earning power), but its legal charge on assets at least gives it a "nuisance value," which ensures a minimum consideration for its interests when things go awry. Directors, however, have little compunction in meting out heavy sacrifices to Preference shareholders if "reconstruction" becomes necessary. This is particularly the case as regards arrears of dividend.

The real congenital weakness in the position of the Preference share is its disposition to fall between two stools. It suffers from the same disability as a certain body of politicians at Westminster. It represents a "middle party." Investors putting safety first are inclined to plump for the Debenture, which, with all its limitations, is the most conservative form of industrial security known to mankind. On the other hand, investors who are willing to lay odds on future progress, so long as they can draw their winnings in due course, will always be attracted by the Ordinary share. The Ordinary shareholder stands all the racket of bad times but in the long run he holds one trump card in his hand. Despite the worst depressions, the world's wealth, on a long view, has increased and is increasing. The Ordinary shareholder reaps the fruits of its progress.

The purchaser of a fixed-interest share gives away much in relinquishing this right. One thing only can compensate him—that his income is "fixed" in a positive as well as in a negative sense. No share which carries both a limited income and a high industrial risk can be an attractive proposition.

There are some shares, like the 5 per cent Cumulative First Preference of the British American Tobacco Company, which are covered many times by profits and have no

Debentures in front of them. These, for all practical purposes, are indistinguishable from first-rate Debentures. There are, however, other Preference shares which carry an indubitable industrial risk without participation in the fruits of good times.

The type of Preference share whose investment appeal is most difficult to perceive is one which is covered, as to dividend, not much more than twice or three times in a business liable to considerable fluctuations in earnings. During a cyclical recession, British manufacturing activity may decline by 10 to 15 or 20 per cent. But the falling off in the net profits of a particular company may be very much greater. The explanation is that a decline in trading activity involves, other things being equal, a corresponding decline, not in net profits, but in gross turnover. Suppose, for instance, a company in a good year showed the following results—

		£
Gross Receipts on Turnover		1,000,000
Expenses—		
"Prime Costs" (Wages, Materials, and other expenses, varying wholly or partly with industrial operations)	600,000	
"Overhead Charges" (Salaries, Heating, and Lighting, Local Rates, Depreciation, etc., which do not vary with industrial operations)	250,000	
Debenture Interest, Directors' Fees, etc.	50,000	
		900,000
Net Profits earned for Dividend . . .		100,000
Preference Dividend Requirements (twice covered by Net Profits) . . .		£50,000

Let it be assumed, however, that in the next year the company's turnover is reduced by 15 per cent. In practice,

it is unlikely that the "variable" items would show anything like the same reduction in so short a period. If, however, a super-management succeeded in bringing down prime costs by the full 15 per cent, the following state of affairs would ensue:

		£
Gross Receipts on Turnover		850,000
Expenses—		
"Prime Costs" (reduced by full 15 per cent)	510,000	
"Overhead Charges" (as before) .	250,000	
Debenture Interest, etc. . .	50,000	
		810,000
Net Profits, earned for Dividend . .		40,000
Preference Dividend Requirements . .		£50,000

It will be seen that a 15 per cent recession of trade has reduced net earnings by as much as 60 per cent, and the Preference dividend is no longer fully covered. In these conditions it is likely that the company will have paid its interim dividend, but, unless it has reserves on which to draw, will pass its final dividend.

If the shares are cumulative, and the depression is only temporary, the Preference shareholder will receive his arrears later on, when prosperity returns. But if he desires to sell his shares in the meantime, he will suffer a heavy capital loss as a result of the inevitable fall in the market price.

Investors who wish, as far as possible, to eliminate "industrial risks" in a period of depression will be well advised to concentrate mainly (1) on industrial Debentures, or (2) on Preference shares which have a first charge on profits, or depend on earnings in an exceptionally *stable* industry, or are covered at least five times by normal earnings in a progressive business. The amount of "fixed expenses" of any given company, in relation to those which are "variable," and can be adjusted downwards in bad

times, is an extremely important matter. On British railways, for instance, only about 40 per cent of expenditure varies directly with the volume of traffic. To take another example, British Celanese, in a relatively good year, had total gross profits, on a twelve months basis, of £1,976,000, but a long list of items, most of them coming under the heading "fixed expenses," reduced the earnings available for Preference shares to £386,000. A decline of 19·5 per cent in gross profits would have been sufficient to wipe out 100 per cent of the amount available for the Preference shareholders. Depreciation, incidentally, is a prior charge, and investors should remember that in all "new" industries it tends to be heavy.

Some industries, again, are notorious for wide profit fluctuations, even among the best concerns. The textile trade is a case in point. In five recent years, J. & P. Coats' total gross profits fluctuated between £4,077,000 and £2,165,000, i.e. 30 per cent on either side of a mean point of £3,121,000. In the same period, the Fine Cotton Spinners' profits varied between £1,273,000 and £518,000, and those of the Bleachers and Dyers Association between £1,006,000 and £628,000.

Other trades are, by their very nature, far more stable. Real property companies in a settled and densely populated area are an excellent example. The net receipts of the City of London Real Property Co. varied in five years only between £644,000 and £563,000, i.e. approximately 6½ per cent on either side of £603,500. The income of the Law Land Co. was even more stable, fluctuating merely between £212,000 and £229,000—in other words, by approximately 4 per cent on either side of the mean point of £220,500.

Old-established investment trusts show the same phenomenon. Among "trading" companies, the tobacco "combine" concerns have shown conspicuous stability of earnings since the War. The only exception to the rule which the

investor should admit arises in the case of companies whose income is on a definitely rising curve. Even in this case, too rapid a growth may suggest the likelihood of an early setback.

Instances might be multiplied, but the investor can best supply them for himself. It is evident that the greater the liability of any company to fluctuating profits the greater the cover required on its Preference shares. The most speculative of all concerns are new companies. No new venture, capitalized so as to leave Preference shareholders covered no more than twice or three times, has any claim on the attention of the conservative investor. A company which issues Preference shares after making a series of losses, in order to take its assets out of pawn, is fit only for heroes to invest in.

Liability to fluctuation is a drawback inherent in every branch of industry, in greater or less degree, and no form of industrial security enjoys one hundred per cent immunity from its consequences. Many Preference shares, however, have a disability of another character, which is all their own. Although holders may have their interests gravely prejudiced by mismanagement, they are frequently denied all power of interference, unless and until their dividends fall into arrears. It is the exception rather than the rule to find Preference shareholders given the right to vote at general meetings.

An issue of £100,000 7½ per cent Cumulative Preference shares made by a company with a household name, just before this book was written, afforded a typical instance of what may be described as taxation without representation. Judged purely from the income-yielding point of view, the shares were a not unreasonable proposition. The company had a valuable goodwill which formed no part of the purchase price, and the dividend was covered generously on the basis of past profits. The Preference shares, however,

were non-voting, so that the interests controlling the company obtained £40,347 in cash (as part of the purchase price), and £59,653 in new working capital from the public, while retaining their sovereignty undiminished by one jot or tittle.

The non-voting Preference share under British company law, as it now stands, is, in fact, an ingenious instrument by means of which a company can obtain public capital and retain an essentially private control. The Greene Committee on Company Law, whose recommendations led to the passing of the Companies Act of 1928, was urged, from an influential quarter, to recommend the abolition of the non-voting Preference share. The Committee failed to do so. Its judgment was swayed to an appreciable extent by recognition of the existence of innumerable other devices, such as low denominational issues, plural voting shares, etc., by means of which vendor interests could, if they wished, retain control of any company.

CHAPTER IV

PREFERENCE *versus* ORDINARY SHARES

Do Preference shareholders relinquish too much in return for priority rights?—Results, over a 17-year period, of Preference and Ordinary share investments in a large company—Prosperity and adversity—Preference shareholders' sacrifices in reconstruction—No protection against long-period forces—The case for sound participating Preference shares.

THE confusion of current thought on investment matters is well exemplified by the attitude of many responsible advisers towards the whole question of investment in Preference shares. The tradition dies hard that the security for a Preference share is of quite a different genus from that on an Ordinary share. Many "safety first" investors, therefore, who will not look at equities, believe that "speculation" is practically eliminated from a well-covered Cumulative Preference share in a seasoned company in an established industry. If, however, the troubled years since the War have taught anything, it is that the rock-bottom security for Preference and Ordinary shares is the same, that the two stand or fall together in the long run, and that investors in Preference shares are frequently asked to relinquish far too much in the way of income and control, in return for "security" which, when really tested, is often strangely elusive.

Investors who question these statements should examine the too-ample records of large companies in British industries which have encountered serious difficulties since the War. The economic conditions of the present time are curiously significant. World demand is changing and, economists declare, is much more fickle than before the War. The centre of gravity of British industry has shifted, not temporarily but permanently, and many basic trades have lost much of their pre-War prosperity.

Few people have realized the extent of recent changes. During the seven years following 1923 (when the Ministry of Labour statisticians first showed national unemployment figures with their present wealth of detail) the artificial silk industry in Great Britain increased its employed labour force by 79 per cent, electrical engineering by 49 per cent, and the distributive trades by 40 per cent. During the same period, however, the number of workers employed in the steel industry declined by 21 per cent, in the cotton textile trade by 25 per cent, and in coal-mining by 31 per cent. In the last-named groups—and in many others—certain companies found their prosperity undermined by circumstances over which they had little control. The experience of their Preference shareholders afforded an interesting test of the merits of such shares in times of prolonged difficulty.

It may be of interest to set out the results of an inquiry into the experience of one such company. The concern in question has been chosen because it is representative of many others. Let it be supposed that, in the year before the Great War, Mr. John Doe, having an appreciable sum to invest, desired to secure a moderate income, with a high degree of safety. Accordingly, he chose a Cumulative Preference share in an old-established company with a consistently good profit record, in a great basic industry in which Great Britain had enjoyed unchallenged world leadership since the industrial revolution. As the products of this industry represented nearly 25 per cent of the total exports of British goods at that date, Mr. Doe rightly argued that the interests of his investment, and those of British prosperity, were indissolubly bound up with each other.

Stock Exchange records show that Mr Doe, buying at the mean market price of the year, obtained 1,000 £1 5½ per cent Cumulative Preference shares, covered 13½ times by profits, at 22s. 6d. per share. A colleague, Mr. Richard Roe, being

of a less conservative nature, decided to purchase 1,000 £1 Ordinary shares in the same company. These he obtained at a mean market price of 21s. 6d., so that his holding cost him £1,075, exclusive of duties and commission, against Mr. Doe's £1,125.

The subsequent history of these two investments is shown in the table on p. 39. The lessons to be learned from the table amply repay the time spent in its scrutiny.

The story falls into two parts—a period of prosperity from years I to IX, and one of adversity from year X onward. Naturally, it is in prosperous periods that the Preference shareholder gives most away. The average profits of the company, shown in the table, during years I to IX, were 58 per cent higher than in the datum year I, when the two imaginary investors purchased their holdings. The rare and refreshing fruits of prosperity, however, eluded the grasp of Mr. John Doe, the Preference shareholder. The "earnings" cover on his shares, it is true, rose from 13·4 times the annual dividend in year I to an average of 21·1 times, and a maximum of 41·2 times in the boom year VIII. From this rise, however, Mr. Doe derived merely a moral satisfaction. The lion's share of the enhanced profits was paid away to the junior shareholders; only the residuum remained in the business to increase future earning power and strengthen the "backing" of the Preference shares.

The "fixity" of dividends tended to prevent the capital value of Mr. John Doe's Preference holding from appreciating as the company's position improved. In fact, as the period was marked by a vast War-time creation of new fixed-interest securities by the British Government, the general rate of interest tended to rise, and Stock Exchange quotations for existing Preference shares to decline. At the end of the period, Mr. Doe's holding showed a depreciation of nearly 31 per cent below its "book cost." The experience of these "good" years, in short, showed somewhat painfully that the

Preference and Ordinary Shares

	Year		Net Profits	5½% Cum. Pref. £1 (£250,000 Issued) Dividend—No. of Times Covered	5½% Cum. Pref. £1 (£250,000 Issued) Total Div. on £1,000 Nominal (Tax Payable)	5½% Cum. Pref. £1 (£250,000 Issued) Market Value £1,000 Nominal	Ordinary £1 Amount Issued	Ordinary £1 Dividend Rate (Tax Free)	Ordinary £1 Total Income on Original £1,000 Nominal[1] (Tax Free)	Ordinary £1 Market Value £1,000 Nominal[1]
			£		£	£	£	%	£	£
War Years	I	Prosperity	184,164	13·4	55	1,125	550,000	10	100	1,075
	II		114,584	8·3	55	1,125	550,000	10	100	1,163
	III		135,594	9·9	55	1,063	550,000	10	100	1,363
	IV		232,082	16·9	55	1,030	775,004	12½	125	1,813
	V		224,604	16·3	55	971	1,218,275[2]	12½	125	2,225
	VI		359,043	26·1	55	971	1,981,736	11⅓	145·83	2,954
	VII		471,140	34·3	55	971	3,526,644[3]	12½	156·25	2,483
	VIII		567,023	41·2	55	846	3,526,644	12½	156·25	2,813
	IX		325,168	23·6	55	779	4,137,382	5	65·5	1,317
Post-War Years	X	Adversity	86,993	6·3	55	813	4,152,030	Nil	Nil	1,096
	XI		200,903	14·6	55	938	4,154,155	Nil	Nil	1,279
	XII		193,413	14·1	55	846	4,154,155	Nil	Nil	879
	XIII		*243,954*[4]	Nil	27½	750	4,154,155	Nil	Nil	708
	XIV		11,168	0·8	27½	721	4,154,155	Nil	Nil	550
	XV		*137,447*[4]	Nil	Nil	596	4,154,155	Nil	Nil	433
	XVI		3,339	0·2	Recon-struction	500	Recon-struction	Nil	Nil	363
	XVII		48,305	3·5	Nil	471	1,297,928	Nil	Nil	258

[1] Allowing for free bonus issue of 1 in 4 in Year V, but not for sale of renunciation rights in connection with cash issue below market price in Year VII.
[2] Including capitalized bonus, 1 in 4. [3] Issue to shareholders at 25s per share. [4] Loss.

Note. Reconstruction in Year XVI.—Preference shares lost all arrears of dividend; were made non-cumulative for some years; interest raised to 6 per cent. Ordinary written down to 4s. per share.

"security" for Preference shares did not extend to security of capital, so long as the company remained a going concern.

Mr. Richard Roe, holding 1,000 Ordinary shares, had a more satisfactory experience than his colleague. Prosperity, in his case, was reflected in enhanced income. Including the dividends on 250 Ordinary shares allotted to him as a capital bonus in year V (but neglecting the value of the "rights" in a subsequent cash offer, which he did not take up), his total income during the nine prosperous years was £1,074, free of tax. During the same period, his Preference-holding colleague received £495, subject to tax. The capital value of the Ordinary shareholding rose with the company's prosperity, and at one time showed an appreciation of 175 per cent over its "book cost." Even at the end of the period, when a premonition of coming ills found expression in a sharp drop in Stock Exchange quotations for the company's shares, the Ordinary shareholder could still have realized his portfolio at 22½ per cent above its original cost. These figures, it should be emphasized, are not hypothetical, but are based on the published balance-sheets of a still existent company and the records of the Stock Exchange.

The statistics so far considered, of course, show the case for Ordinary shares at its strongest. In times of industrial prosperity Preference shareholders expect to pay, by way of the limitation of their earnings, for the security they hope to enjoy in bad times. Further, the War years were, as all admit, an abnormal period. The purpose of this part of the inquiry, however, is merely to throw into sharp relief the very considerable extent of the sacrifice involved in relinquishing all part or lot in a company's "equity." How far, in this particular case, were Preference shareholders compensated when trade conditions showed a *volte-face*, and disaster overtook the Ordinary shareholders? The table reveals, in the clearest possible fashion, the cerebral processes of those in control during the later post-War period of stress

and strain. From years X to XII, it was confidently assumed that the company's difficulties were temporary. Preference dividends continued to be earned and paid, but payments on the Ordinary shares ceased abruptly. By year XIII, however, it was evident that the company was suffering, not merely from cyclical depression, but from a permanent threat to its earning power. The decline in profits did not conveniently stop at the amount required for Preference dividends. On the contrary, heavy losses in years XIII and XV made serious inroads into the reserves out of which Preference dividends might have been paid. Though the shares were cumulative, they received only half their full dividend in years XIII and XIV, after which payments came completely to an end.

In year XVI, it became necessary to reconstruct the company. The "paper" rights of the Preference shares went by the board. All dividend arrears were wiped out. The shares were made non-cumulative, until certain dividends had been paid on the junior shares—though, as a consolation, Preference shareholders obtained the right to an extra ½ per cent per annum *whenever profits were earned and the directors decided to distribute them*. The Ordinary shares were written down on paper by 80 per cent, but as their equity rights were only slightly encroached upon, their sacrifice was more nominal than real. That the concessions made by the Preference shareholders were real and substantial was shown in the first year (XVII) after the reconstruction, when the company's earnings covered Preference dividends more than three times, but the directors, taking advantage of the non-cumulative character of the new Preference shares, paid no dividend, leaving holders without any legal claim in respect of its omission.

So much for the results of an investment in the Preference and Ordinary shares, respectively, of a company which made large profits before and during the War, but was

subsequently attacked by pernicious anæmia—due primarily, not to any weakness in its management or financial policy, but to a permanent change in the world position of its industry.

The conclusions suggested by this survey may be briefly summarized. It is necessary to disclaim strongly all intention of "attacking" Preference shares. Undoubtedly, prior rights to available profits confer a valuable privilege on Preference shareholders. That Preference shares have lasted for so long is a proof of a certain harmony with their environment. They appeal to many investors who are willing to make some sacrifice of income in the interests of security. They appeal, also, to many companies, which foresee their ability to earn an appreciably higher rate on the money obtained from Preference share issues than they contract to pay out upon the shares.

The "security" which Preference shares enjoy, however, is frequently exaggerated. Preference and Ordinary dividends have precisely the same ultimate security—earning power. "Cumulative" rights may protect a Preference shareholder against *short-period depressions* in trade, but they afford no protection whatever against *long-term changes* in industry, or against bad management or mistaken finance. All these are omnipresent industrial risks. In a reconstruction, Preference arrears are the first thing thrown overboard. In cases where heavy Preference arrears have, in fact, been paid off (as happened, for example, during the rehabilitation of Austin and Leyland Motors, after the post-War depression) this action has been contingent on a more than usually rapid recovery in earning power.

A purchase of Preference shares does not protect investors against loss of capital by market depreciation. In bad times, the accentuation of the industrial risk inherent in Preference shares may lower their market prices. Periods of good trade, paradoxically, may also have a depressing

effect, due to the public tendency, discussed in an earlier chapter, to "switch" from fixed-interest stocks to equities, and to the fact that trade activity (in its latter phases at least) generally means higher money rates, which react unfavourably on fixed-interest securities.

In the light of these conclusions, one may strongly contend that it is asking too much of a Preference shareholder to give up all rights to the fruits of long-term progress, while he remains exposed to the effects of long-term decadence. In other words, the participating Preference share should be more widely employed. There is much to be said for a share which is preferential up to, say, 7 per cent, and subsequently receives 1 per cent for every 1 per cent paid on the Ordinary above, say, 10 per cent—without limit. The difference of 3 per cent between the two returns is a fair measure of the price which Preference shareholders should pay for their priority rights.

The factor of "gearing" (see Chapter IX) is also very relevant to the issue. The value of priority rights diminishes as the ratio between fixed capital and total capital increases. Broadly speaking, the old rule is sound that Preference shares should not represent more than a third of a company's issued capital.

CHAPTER V

ORDINARY SHARE EARNINGS

RECAPITULATION of conclusions regarding Debentures and Preference shares—Earning power is ultimate security for all stocks—Gilt-edged no exception to this rule—Basis of investment appeal of Ordinary shares is direct participation in growth of national income—What is "earning power"?—Method of ascertainment from published company reports.

BY way of preface to a discussion of ways and means of measuring the investment appeal of Ordinary shares, it may be of advantage to recapitulate the conclusions suggested in preceding chapters as regards the position of Debenture-holders and Preference shareholders. The most significant fact revealed by post-War experience has been that, whenever a company has fallen on really bad times, the holders of Preference shares and Debentures have suffered. A close examination of all the big post-War reconstructions in the iron and steel, engineering and textile industries, for example, shows that when a company's earning power has been undermined, the *priority* powers of fixed-interest shareholders have proved a broken reed.

Preference dividends, however "cumulative" they may be—on paper—are paid out of profits, and when there are no profits, past or present, there are no dividends. Debenture-holders have discovered that powers of foreclosure on plant and assets are of limited practical utility, since buildings and machinery, which may be sold at a handsome figure when a company's earning power is good, are little more than bricks, mortar, and old iron in the hands of a liquidator, when their ability to earn profits has disappeared.

The truth is that there is not a single British security which is not dependent upon earning power, directly or indirectly. This rule applies even to Gilt-edged securities. The aggregate of all the earning power of Great Britain is

what economists call "the national income." It is thus a comparatively simple matter to calculate the "cover" for British Government securities. In 1913–14, the total tax revenue of Great Britain represented 7 per cent of the national income, and the service of the National Debt called for 15 per cent of the total tax revenue. Twelve years after the War, tax revenue was just under 20 per cent of the national income, and the Debt service called for 44 per cent of the tax revenue. In other words, the service of British Government stocks was covered 95 times in the pre-War year, and approximately 11½ times in the post-War period.

The Government, however, has priority over everyone else for its share of the national income. A public company has no claim, as of right, on any part of the national income. Its share depends entirely on how much of that income its organizers can persuade the general community to make over to it, in return for the goods and services it produces. It is only when this share has been earned that the priority rights of the Debenture-holders and Preference shareholders come into the question at all.

Thus it will be seen that the generally accepted view that the ultimate security for a fixed-interest stock is something different from that of an Ordinary stock is a dangerous misconception. The security in both cases depends on earning power, which is not, and can never be, "fixed." The "protection" which Preference shareholders and Debenture-holders enjoy is protection against *short-term fluctuations in earning power,* against which the Ordinary share earnings serve as a buffer. If the investor is prepared to ignore short-term fluctuations, he must conclude that the difference in "risk" between an Ordinary share and a Debenture or a Preference share is one of degree and not of kind. The dividends on a fixed-interest stock have, and those on an Ordinary share have not, a limit "at the top"; neither kind has a limit "at the bottom," short of zero.

The basis of the appeal which Ordinary shares make to the conservative long-term investor is the fact that, despite all cyclical fluctuations, the world's wealth has increased, and is increasing, decade by decade. To take an example from a single country, the following figures show the growth of the total net national capital of Great Britain over sixty years—

Year	Amount of National Capital
	Million £
1868	6,115
1875	8,548
1885	10,037
1895	10,663
1905	13,036
1914	14,300
1928	18,045

The Ordinary share is the sole instrument by means of which investment can be directly linked with future economic expansion.

From this premise follows a most important conclusion, which is far too frequently overlooked. The "security" for an Ordinary share is dynamic and not static. It is folly to buy and sell such a share on the basis of a single year's results, or on considerations of "current yield" alone. Wise investors will confine their attention to seasoned shares with a sufficiently long earnings record for long-period statistical tests, whose real security is independent of short-term movements. Conversely, they will regard rocket-like upward movements in earnings as suggesting a need for caution, on the ground that the pace is much too hot to last.

Before any investor, however, can form an opinion as to the merits of a particular Ordinary share, he must have a clear idea as to what "earnings" are, and what they are not. In succeeding chapters a number of methods are suggested for measuring the value of Ordinary shares.

These are based on earning power, in every case, but this is an abstract conception and must be translated into terms of pounds, shillings and pence.

The outward and visible expression of any company's earning power is its profit-and-loss account. "Net profits," however, is a term whose connotation varies with every board of directors, and before any set of figures can be safely used for comparative purposes a lowest common denominator for "profits" must be found. The only logical figure which can be taken is that of net earnings accruing to the Ordinary shareholder after all payment of internal and external charges.

Prima facie, this definition seems reasonably clear. Its application, however, involves a number of nice distinctions, which can best be made clear by an example. Suppose a company declares what is dubbed by the directors a "total profit" of £100,000, and allocates it as follows—

		£
(1)	*Total Profit*	100,000
(2)	Depreciation	10,000
(3)	Reserve for Taxation	25,000
(4)	Directors' Fees	3,000
(5)	Written off Goodwill	5,000
(6)	General Reserve	5,000
(7)	Reserve for Equalization of Dividends	2,000
(8)	Reserve for Bad Debts	1,000
(9)	Reserve for Depreciation of Securities	1,000
(10)	Debenture Interest	10,000
(11)	Preference Dividend	15,000
(12)	Ordinary Dividend	20,000
(13)	Added to Carry-forward	3,000

The term "total profit," incidentally, must be applied only to profits earned during the year. If the alleged total includes such items as "Past provision for taxation, not now required," the investor should strike these out immediately. As regards the appropriation of profits, it is obvious that no

money which is paid out of the business before the Ordinary shareholder's rights begin to operate can be regarded as "net earnings," from his point of view. This eliminates items (4), (10), and (11)—namely, directors' fees, Debenture interest and Preference dividend.

The remaining items, down to item (9), all represent money which remains ostensibly in the business. Some items, however, cover expenditure of a capital and revenue nature, which is incidental to the earning of profits, and must be allowed for, like any other expense. Liability to taxation is, unfortunately, an inevitable consequence of the earning of profits, and the £25,000 reserved to meet this liability will, presumably, eventually be transferred from the company to the Exchequer. Bad debts are a form of loss, and if allowance is not made for them real profits will, *pro tanto*, be overstated. The same remark applies to the depreciation of securities.

Finally, the company's plant and machinery are one year nearer to the scrap heap. In other words, a year's value of the company's fixed capital assets has been "used up" in the process of earning profits. The £10,000 for depreciation is, therefore, as much an "expense" as any other item on the debit side of the profit and loss account. Thus, items (2), (3), (8) and (9) fall out.

It will be noted that, originally, five items were classified by the directors as "reserves," but only two now remain. Their survival involves a principle of the utmost importance to Ordinary shareholders. The "reserves" which have been eliminated are of a "specific" or "tied" nature, and those which remain of a "general" nature. It is occasionally anything but easy to differentiate between the two, but there is one criterion which the investor can apply with fair confidence. Liabilities which the company, sooner or later, *must* meet, willy-nilly, in order to pay its way and keep its capital intact, are "specific," and provision for

them must be deducted from declared profits. Payments which the company need not make unless it wishes to do so (such as future dividend payments) are "general" and need not be so deducted. Under the latter heading, clearly, come items (6), (7) and (13). This question is discussed in greater detail in Chapter XIII.

Item (5), "written off goodwill," frequently gives rise to misunderstanding. "Goodwill," unlike plant and machinery, is not a wasting asset. If the company has been earning good profits, the real value of its established connection may be higher than twelve months previously. Though many companies consider it "good form" to write off their goodwill, the amounts set aside for the purpose are really appropriations to general reserve, called by another name—so long, at least, as the company maintains its earning power intact.

The true measure of earning power, for the Ordinary shareholder in this imaginary company, has now been arrived at by a process of elimination. It is the sum of items (5), (6), (7), (12) and (13), namely, £35,000.

It may be that the real earnings are greater, because the directors have deliberately over-estimated depreciation, or some other charge on profits, in order to create a "secret reserve." The investor, however, can but take the figures as they stand.

The directors might have chosen to pay out the whole of the £35,000 to the Ordinary shareholders, without leaving any other liabilities unprovided for, and without reducing the company's effective capital. The fact that only £20,000 has, in fact, been distributed, does not involve any organized robbery of the Ordinary shareholders. The remaining £15,000 still stands to their credit, but has been *capitalized* (effectively, though not legally). The money will be used in the business, and, so long as it remains there, will have exactly the same effect on future profits as if the whole

£35,000 had been paid in dividends and the shareholders had subsequently been asked to subscribe £15,000 to a new issue of capital.

So much for the ascertainment of earnings, as a preliminary to the measurement of the "security" for an Ordinary share. A technique by means of which this basic quantity can be applied to the results of any given company will be discussed, step by step, in succeeding chapters.

CHAPTER VI

A TECHNIQUE FOR MEASURING ORDINARY SHARES

DANGEROUS to buy Ordinary shares on results for one or two years—Measurement of earnings—Ascertainment of effective capital—Example—Compiling a ten-year table—The popular method—Its dangers.

THIS chapter deals with the possibility of "measuring" the security of Ordinary shares by a series of simple arithmetical yardsticks. The methods suggested may, it is hoped, be of service to investors of every kind, but the author ventures to commend them to the particular consideration of large corporate investors. The matter is dealt with throughout from the viewpoint of the long-term investor, who is prepared to hold a progressive share for a period of years, rather than that of the speculator, who is concerned with a short-term capital profit.

To measure "security" in the sense in which the term is used throughout this book, the investor must concentrate his attention on the trend of earning power of the company whose results he is dissecting. It is dangerous to buy or sell any share on the figures merely of one or two recent years, however spectacular those figures may appear at first sight. To obtain even a moderately reliable working idea of a company's position, it is necessary, in the majority of cases, to analyse its returns over a period of at least nine or ten years. There is no special virtue in a decade for this purpose, but it happens to be the approximate length of the average trade cycle.

The *modus operandi* for calculating a company's earnings in any given year, by reference to its published accounts, was outlined in the last chapter. Particular care must be taken to include, and exclude, similar items throughout the

period over which results are examined, so that, at the end of the first stage of the analysis, the investor will have a series of nine or ten comparable figures of "profits earned for Ordinary shareholders." Earnings, however, are meaningless unless they are related to the capital employed during the period in which they have accrued. Judged by earnings alone, a company may appear decidedly progressive, but examination may show that every pound of new capital introduced into the business is obtaining a decreasing return. To measure "effective capital" is a difficult matter. The figures of paid-up capital in balance-sheets afford a basis for stamp duties, market quotations and annual dividend ratios, but they are no guide to the real capital used. The difference between £1 of capital which comes to a company by way of retained profits, and the same amount (in money) subscribed from outside, is purely formal—£100,000 in a general reserve, £100,000 capitalized as bonus shares, and £100,000 raised by a prospectus issue in the public market, all have exactly the same earning power in the business world.

For the present purpose, therefore, the investor should endeavour to ascertain how much capital is *actually employed in the business*, on behalf of the Ordinary shareholder, and not be content merely to take the balance-sheet figure of paid-up capital, which is purely a legal and accounting quantity. The following is suggested as the simplest method of discovering "Ordinary capital effectively employed." At the beginning of the first year in the "series" of results to be considered, the investor should add together (*a*) the company's paid-up Ordinary capital; (*b*) any visible reserves of a "general" nature appearing in the balance-sheet; (*c*) any additions thereto taking effect from the beginning of that year, together with the whole of the "carry-forward" to the next year. In the next succeeding year he should deduct, from the total earnings applicable to Ordinary

shares, the total dividends paid out. The residuum represents profits which have been "capitalized" (temporarily or permanently). To these must be added any capital issues made during the year (in terms of the money received, not of nominal capital). The addition of these two figures to the previously ascertained "effective capital" figure gives the total capital employed during the succeeding year. The same process is applied to each succeeding year in the "series." Deductions are made, of course, whenever profits are over-distributed or reserves drawn upon.

For example, at the beginning of Year I of the last decade, the investor may discover that the balance-sheet of the X.Y. Company, Limited, showed the state of affairs set out on p. 54.

The "effective ordinary capital" with which this company opened business on the first day of Year I was not £80,000, shown as "Paid-up ordinary capital" in the balance-sheet, but £150,550, made up, according to the formula already given, in this wise—

	£
(*a*) *Paid-up Ordinary Capital*—	
As shown in Balance-sheet . . .	80,000
(*b*) *Visible Reserves of a General Nature, appearing in the Balance-sheet*—	
General Reserve	50,500
Reserve for Equalization of Dividends[1] .	10,000
(*c*) *Additions thereto, with Amount Carried Forward*—	
Added to General Reserve . . .	2,500
Carried Forward	7,550
Total Effective Capital with which Year I begins	£150,550

[1] NOTE. The Taxation Reserve and the Reserve against Forward Contracts are not included, since these are of a specific character, not available for general purposes. (See page 48.)

X.Y. COMPANY, LIMITED—BALANCE SHEET AS AT END OF YEAR O

(i.e. the day before Year I began)

Liabilities	£	*Assets*	£
Paid-up Capital. 7% Preference Shares of £1 each	20,000	Land, Buildings and Plant	85,000
Paid-up Capital. Ordinary Shares of £1 each	80,000	Stock-in-Trade	30,000
General Reserve	50,500	Sundry Debtors	35,000
Reserve for Equalization of Dividends	10,000	Trade Investments	12,500
Taxation Reserve	4,000	Government Securities	18,000
Reserve against Forward Contracts	2,500	Cash in Hand and at Bank	21,450
Sundry Creditors	15,500		
Profit and Loss Balance—			
Brought Forward	2,700		
Year's Earnings	16,750		
	£201,950		£201,950

The profit-and-loss appropriation account for the Year O, appears thus:

X.Y. COMPANY, LIMITED—APPROPRIATION ACCOUNT, YEAR O

	£		£
Preference Dividend	1,400	Brought Forward from Previous Year	2,700
Ordinary Dividend at the rate of 10 per cent	8,000	Net Earnings during Year O	16,750
Addition to General Reserve	2,500		
Carried Forward to Next Year	7,550		
	£19,450		£19,450

In the Year I, the company makes a net trading profit of £19,000, from which it allocates £2,500 to Taxation Reserve, and £500 to Reserve Against Forward Contracts, leaving a balance of £16,000. The Preference Dividend takes £1,400, so that the Earnings for the Ordinary shareholders are £14,600. These earnings are equal to 18¼ per cent. on the paid-up Ordinary capital of £80,000, and the company's earning power appears to be distinctly above the average. Actually, however, as the capital effectively employed has been shown to be £150,550, the real earning power percentage is only 9·7—a much more moderate figure.

The results for Year I may, therefore, be set out thus:

X.Y. COMPANY, LIMITED

	Effective Ordinary Capital	Ordinary Earnings	Earning Power Ratio
	£	£	%
Year I	150,550	14,600	9·7

The company pays a dividend of 12½ per cent. on its Ordinary shares, absorbing £10,000. The residuum—£4,600—represents money left in the business, and is capable of earning profits in Year II. It is therefore added to "Effective Ordinary Capital," and that item, for Year II, is raised from £150,550 to £155,150. At the end of Year II the Ordinary earnings (after all deductions, including Preference share dividends) are found to be £16,790. The tabular statement of results thus becomes—

X.Y. COMPANY, LIMITED

	Effective Ordinary Capital	Ordinary Earnings	Earning Power Ratio
	£	£	%
Year I	150,550	14,600	9·7
Year II	155,150	16,790	10·8

For Year II the company repeats its 12½ per cent Ordinary dividend, requiring £10,000, and leaving £6,790 to be added to Effective Ordinary Capital, bringing that figure to £161,940. The directors also announce, at the same time, an issue of new capital to Ordinary shareholders, to an amount of £20,000, at the price of 30s. per £1 share. This issue increases the paid-up capital, appearing in the balance-sheet, by £20,000, but actually enhances the available resources of the company by £30,000 (the balance of £10,000 appearing in the balance-sheet as "Share Premium Reserve"). The "Effective Ordinary Capital" for Year III must thus be raised from £161,940, by the addition of £30,000 ("from outside"), to £191,940. In Year III the Ordinary earnings are £18,250, and the table of results is as shown—

X.Y. Company, Limited

Year	Effective Ordinary Capital	Ordinary Earnings	Earning Power Ratio
	£	£	%
I . .	150,550	14,600	9·7
II . .	155,150	16,790	10·8
III . .	191,940	18,250	9·5

The analysis is continued, year by year, until the complete ten-year table appears as follows—

X.Y. Company, Limited—Ten-Year Earnings Table

Year	Effective Ordinary Capital	Ordinary Earnings	Earning Power Ratio
	£	£	%
I .	150,550	14,600	9·7
II .	155,150	16,790	10·8
III .	191,940	18,250	9·5
IV .	197,690	19,200	9·7
V .	204,390	19,300	9·4
VI .	211,190	19,370	9·2
VII .	217,560	19,450	8·9
VIII .	224,010	19,490	8·7
IX .	230,000	19,510	8·5
X .	235,510	19,520	8·3

This table can scarcely fail to be instructive to any potential investor who is considering the advisability of risking his money in the purchase of a substantial block of the company's Ordinary shares. He will observe that, although the company appears to be in a thoroughly healthy state, and there is not a single year since the beginning of the period when its profits have failed to show some increase, it is significant that, for some years past, *the earnings have not risen in due proportion to the effective capital.* In other words, the company is obtaining a decreasing return on every £1 of new capital it puts into its business. Knowledge of this fact will at once put the investor on his guard, and suggest the advisability of his taking steps to obtain a closer personal knowledge of what is actually happening.

Had the investor used the customary methods of analysis he would never have made this all-important discovery. He would, in fact, have been impressed by the uninterrupted growth in the company's earning power, in terms of its paid-up share capital, and the steady rise in the value of its Ordinary shares in the market. How can one form anything but a favourable impression of a company whose apparent results are—

X.Y. COMPANY, LIMITED —TEN YEARS' RESULTS (OLD STYLE)

Year	Paid-up Ordinary Capital	Ordinary Earnings		Ordinary Dividends		Average Market Value of £1 Ordinary Shares
		Amount	Per Cent of Paid-up Capital	Amount	Per Cent. of Paid-up Capital	
	£	£		£		s. d.
I .	80,000	14,600	18·2	10,000	12·5	36 –
II .	80,000	16,790	21·0	10,000	12·5	40 –
III .	100,000	18,250	18·2	12,500	12·5	39 –
IV .	100,000	19,200	19·2	12,500	12·5	39 6
V .	100,000	19,300	19·3	12,500	12·5	41 6
VI .	100,000	19,370	19·4	13,000	13·0	44 –
VII .	100,000	19,450	19·4	13,000	13·0	44 6
VIII .	100,000	19,490	19·5	13,500	13·5	48 –
IX .	100,000	19,510	19·5	14,000	14·0	52 –
X .	100,000	19,520	19·5	15,000	15·0	60 –

To all appearances, the company is pursuing a soundly conservative financial policy, and, after a check to earning

power per £100 of paid-up capital after the latter's enhancement in Year III, has steadily increased both its earnings and dividends. Investors have been increasingly attracted towards its Ordinary shares, whose average Stock Exchange price for Year I, consequently, has risen by just over 66 per cent over the ten years shown in the table.

Undoubtedly, the company's general position is healthy, above that of the normal run of trading concerns, but—there is a fly in the ointment. No investor could possibly discover, from the above table, that every new £1 of effective capital put into the business—the "marginal pound," as economists would say—was producing lower profits than its predecessors. But this fact may become of first-rate importance if the company decides, in Year X, to double its paid-up capital by an issue of £100,000 new £1 Ordinary shares at a price, say, of 50s. The shares will be eagerly applied for in the market, on the assumption that, in due course, the company will earn, possibly not a full 19·5 per cent on its new shares, but something not very far below that figure. The investor who has been put upon his guard by the figures in the table on p. 56, will realize that the new issue increases the *effective* Ordinary capital, not by £100,000 but by £250,000. During the last six years, as the table shows, the company has had to cope, on the average, only with an increase of £6,300 each year in its effective capital. Yet during that six-year period the return per £100 of effective capital has declined from £9·7 to £8·3. How will the company fare in the task of finding profitable employment for a new increment of no less than £250,000? It may possibly have seized an exceptional profit-making opportunity—by purchasing, for example, the business of a formidable competitor. In the absence of indubitably strong evidence on this point, however, the supposition is that the new capital will earn much less than the old. A simple arithmetical calculation will show that if the average return per

£100 of *effective* capital, under the new conditions, falls under, say, £5, the earning power ratio of *paid-up* capital will be only 12½ per cent. In all probability, therefore, the company will reduce its dividend from 15 per cent to, say, 10 per cent. The market value of the shares will then fall to the neighbourhood of 35s., leaving subscribers to the new issue, at 50s., with a capital loss of £30 on every £100 they invested in the issue.

Clearly, "earning power," as the investor understands the term, must be measured in terms of *effective capital*, and not paid-up capital, described as such in published balance-sheets. At best, the latter figure is merely a convenient, but quite nominal, legal quantity. At worst, it may be a gin for the feet of the unwary investor, a signpost leading him, by way of false inferences, to the loss of a substantial part of his resources.

CHAPTER VII

ORDINARY SHARE CHARTS

DIFFICULTY of obtaining coherent impressions from long series of figures—Pictorial representation—Method of constructing charts of annual results—Fluctuating earnings—"Moving average" charts.

THE investor who considers it a matter of simple prudence to count the cost before going to war, now has at his service a technique for measuring the earning power of any company in which he is interested. The essential figures can readily be extracted from any series of balance-sheets. An investor who lacks these useful documents (which he will receive regularly, if and when he becomes a shareholder in a company) will find that his broker will be ready to supply him with the relevant figures on request. If he is an independent man, who likes to think that the only way to be sure a thing is well done is to do it himself, he may ask his broker merely to forward him past figures of paid-up capital, reserves, earnings, and amounts of dividend, and work out the figures for himself. If he is a considerate man, who regards his broker as a hard-worked professional adviser, who has more than enough to do answering his clients' ordinary inquiries, he may ask merely to be put in touch with one of the regular investment "services" which will give him all he requires for a small fee. Alternatively, he may write for the necessary data to *The Economist*, *The Statist*, or any other reputable financial newspaper.

In every case, he will find himself in ultimate possession of a sheet of paper showing ten or more years' effective capital and ordinary earnings of a particular company. One method of relating the one to the other, in order to discover the trend of earning power, was shown in the last chapter (p. 56). As more and more results become available, however, it will be found increasingly difficult

to obtain a coherent impression covering the *whole* of the data. Even in a ten-year table, one has to deal with ten "effective capital" figures, and ten "earnings" figures, and it is as difficult to keep twenty figures in one's mind, simultaneously, as to drive twenty sheep across a field. By the time one has reached Year VII, one has forgotten what has happened in Years I to III, and the longer the table, the greater the danger of its becoming meaningless.

The only really satisfactory way of overcoming this difficulty is to reinforce the appeal to the mind by an appeal to the eye, by plotting the figures on a chart. It is easy to follow the ups and downs of a line, but decidedly difficult to grasp the meaning and extent of movements in a complex column of figures. Many readers of this book, however, who are not accustomed to regard their intellectual equipment as inferior to that of their fellow men and women, may nevertheless have an inbred and temperamental distrust of "charts." They may be earnestly recommended not to refuse, on this account, to have anything to do with one of the most useful of all statistical devices. Charts, like gardens, frocks and motor-cars, may be extremely simple or very elaborate, but no chart described in this book need present the slightest difficulty to an investor capable of working out a few simple proportion sums.

For the investor's purpose, the best material for charting purposes is a pad of squared paper, which can be purchased for one shilling from any good stationer's shop, exactly as one buys a pad of notepaper. A convenient size is "quarto," and a convenient ruling, "inches and tenths." A crown quarto sheet measures 10 inches by $7\frac{1}{2}$ inches.

The most successful way of charting effective capital and earnings is to show the two, as it were, starting together from scratch in a ten-year race. Which of the two is the faster runner can then be ascertained beyond a peradventure.

A professional statistician would do this merely by "plotting" the two curves directly, on paper ruled to what is called a "logarithmic" scale. Logarithms, to those familiar with their use, are merely labour-saving devices, as useful in their way as sewing-machines or vacuum-cleaners. For the purposes of this book, however, a knowledge of logarithmic methods is not presumed. Accordingly, a method must be found of preparing the figures, already in the investor's possession, for use with a "natural" scale.

It may be recalled that the effective capital and earnings of the X.Y. Company, Limited, for years I to X, were as follows—

Year	Effective Ordinary Capital	Ordinary Earnings
	£	£
I . .	150,550	14,600
II . .	155,150	16,790
III . .	191,940	18,250
IV . .	197,690	19,200
V . .	204,390	19,300
VI . .	211,190	19,370
VII . .	217,560	19,450
VIII . .	224,010	19,490
IX . .	230,000	19,510
X . .	235,510	19,520

No investor who is not a mathematician can say, from a casual inspection, whether a rise in effective capital from £150,550 to £235,510 is proportionately smaller or greater than a rise in earnings from £14,600 to £19,520. Let each figure, however, in Year I be represented by an identical figure of 100. Clearly, if £150,550 is regarded as being equal to 100, then £301,100, which is exactly twice as much, will be represented by 200; and £225,825 (which is half as much again as £150,550) will appear as 150. The working out is an exercise in simple proportion. Thus, to take the "effective capital" figures:—If £150,550 (Year I) = 100, then £155,150

(Year II) $= \frac{155{,}150 \times 100}{150{,}550}$, or 103, to the nearest whole number.

Similarly, for Year III, $\frac{191{,}940 \times 100}{150{,}550} = 127$.

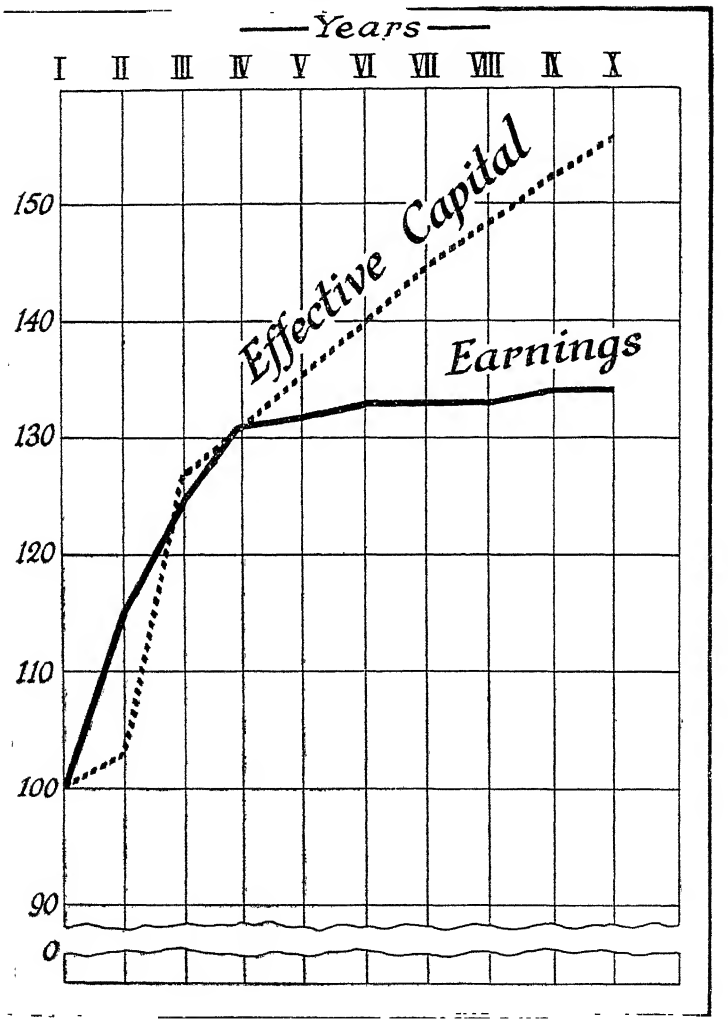
Investors familiar with the elementary use of a slide-rule can save themselves the trouble of calculating the figures, by setting the rule for Year I, and reading off the results for subsequent years. In any case, the necessary working can be done on a few old envelopes, if no more scientific equipment is available. Treating the "ordinary earnings" figures in the same fashion, on the base £14,600 = 100, the following two columns of figures will be obtained—

YEAR I=100

Year	Effective Ordinary Capital	Ordinary Earnings
I . .	*100*	*100*
II . .	*103*	*115*
III . .	*127*	*125*
IV . .	*131*	*131*
V . .	*136*	*132*
VI . .	*140*	*133*
VII . .	*144*	*133*
VIII . .	*149*	*133*
IX . .	*153*	*134*
X . .	*156*	*134*

These figures can now be "charted," as shown on the next page. The chart makes the company's position apparent at the most casual glance. Although earnings have been rising throughout the period, the advance was most rapid in the earlier years, has slowed down very considerably, and, unless some new and unexpected development intervenes, seems destined to cease altogether at a very early future date. At the outset, every £1 of new capital effectively introduced into the business obtained an increasing return,

X.Y. COMPANY LIMITED



so that the "earnings curve" ran *above* the "capital curve," on the chart. The company, however, seems to have over-estimated its new capital requirements when making its public issue of shares at the end of Year II. From Year III onwards, with one exception, the earnings curve has run *below* the capital curve. Up to Year IV, however, the distance between the two was, if anything, tending to decrease. In other words, earning power was more than keeping pace with the increments of new capital "ploughed back" into the business from each year's profits. But from Year IV onwards, the capital curve has tended more and more to outstrip the earnings curve. The company, in short, appears to be highly prosperous when normal stock market tests are applied, but in reality it is stagnant. It is maintaining its earnings only by putting more and more effective capital into its business. If its directors should ever yield to the temptation of distributing dividends up to the hilt (and consequently reducing the annual increments of capital ploughed back to little or nothing), a speedy *fall* in profits may be confidently predicted.

This hypothetical company's position has been dealt with at some length, because it exemplifies the dangers of investment without the previous application of more rational methods than are generally used. The basic "laws" of Ordinary share analysis cannot be too frequently repeated. First, every examination must cover the results of as many years as possible. It is the *trend* which matters, and the returns for a mere two or three years may be useless and misleading. Secondly, earnings and effective capital (not the so-called "paid-up capital" of the balance-sheet) must be set into juxtaposition. Earning power is not absolute but relative, and movements in the one set of figures are meaningless without reference to movements in the other.

Investors who apply these methods will discover, by practice, that while the Ordinary share charts of some

companies have "smooth" curves, like those of the X.Y. Company, others are liable to wide up-and-down movements. Earnings may fluctuate from year to year as a result of trade conditions, labour unrest, and innumerable other causes, so that a company may show a considerable fall in its earnings curve in a particular year, though the *trend* of profits may be upward all the time. The capital curve, similarly, may fluctuate if the company puts large earnings to reserve in good years, and draws on past profits to maintain dividends in bad years. This question will be further discussed in a subsequent chapter. For the moment we are concerned merely with the discovery of a convenient method of eliminating the disturbing effect of such fluctuations from a company's share chart—in other words, of "smoothing out" a jagged curve.

For example, it may be found that the figures of the O.P. Company, Limited, for a ten-year period, analysed and set out on the lines indicated on earlier pages, appear as follows—

O.P. Company, Limited—Yearly Figures

Year	Effective Ordinary Capital		Ordinary Earnings	
	£		£	
I . .	223,200	*100*	25,000	*100*
II . .	228,200	*102*	27,500	*110*
III . .	235,700	*106*	26,500	*106*
IV . .	232,200	*104*	29,250	*117*
V . .	251,450	*113*	35,000	*140*
VI . .	266,450	*119*	29,500	*118*
VII . .	285,950	*128*	33,750	*135*
VIII . .	299,700	*134*	41,750	*167*
IX . .	321,450	*144*	41,500	*166*
X . .	342,950	*154*	35,250	*141*

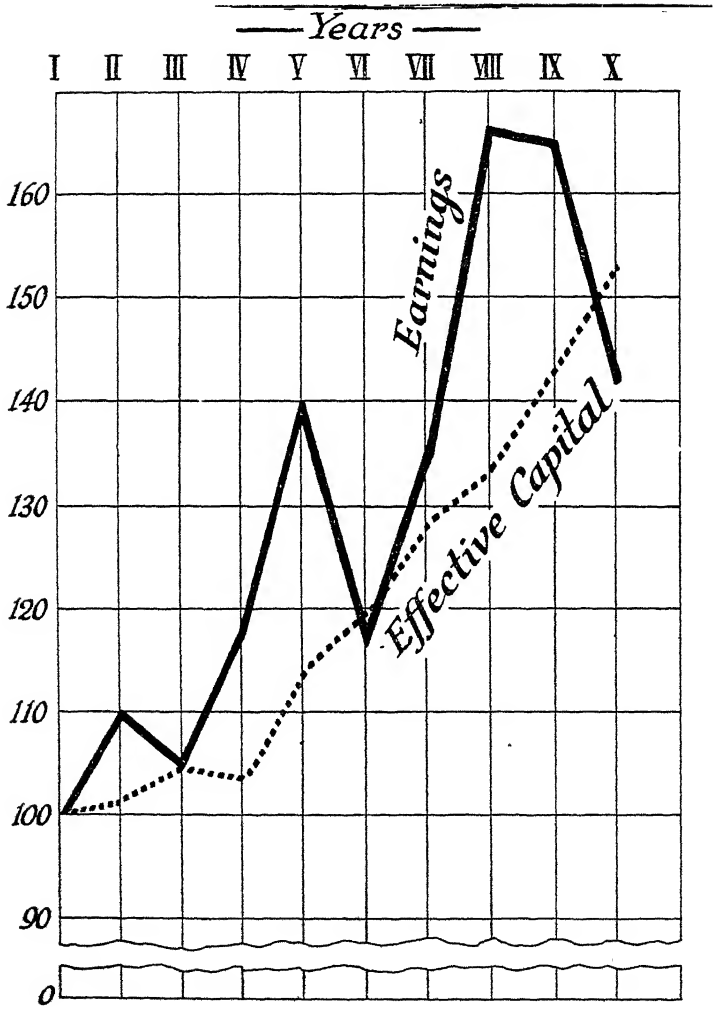
The O.P. Company, Limited, is a concern operating in a branch of the textile industry where demand, being dependent on the whims and caprices of *Madame la Mode*, is liable to incalculable fluctuations from year to year. The

company has an Ordinary capital of £200,000, and at the beginning of the period shown in the table possessed "free" reserves of £23,200. At the outset, the directors paid out dividends more or less "up to the hilt," so that in Years I, II and III, distributions of 10 per cent, 10 per cent and 15 per cent, respectively, absorbed £70,000, out of total profits of £79,000 earned for Ordinary shareholders. A change of policy then occurred, the board determining to limit dividends stringently for the time being, partly to finance an increased business by "ploughing back" profits, without recourse to new issues of capital, and partly to "consolidate" their distributions to shareholders at levels capable of being maintained in bad, as well as in good, years. In Year IV, therefore, the dividend was reduced to 5 per cent, absorbing only £10,000 out of £29,250 earned. The shares at once slumped badly in the market, but investors who had courage and foresight refused to part with their holdings, rightly arguing that the reduction applied only to dividends, not to earning power, and was, in fact, calculated significantly to increase the latter's dimensions in years to come. The company, in fact, paid dividends of 5 per cent in Years IV, V, and VI, 10 per cent in years VII, VIII and IX, and 15 per cent. in Year X, the directors believing that the drop in profits in that year was a purely temporary fluctuation which would not endanger their ability to maintain the higher dividend rate in succeeding years.

A chart of the ten years' results, prepared on similar lines to that of the X.Y. Company, appears on the next page. It is difficult to discover, from this picture, exactly how the company's affairs are "trending." The concern certainly appears to be progressive, since the earnings curve, on the whole, lies above the effective capital curve—but by how much one cannot say. The earnings fluctuations are decidedly steep, and on three occasions the capital curve has "cut" the earnings' curve. At the end of the

O.P. COMPANY LIMITED

YEARLY FIGURES



period, indeed, the capital curve has run ahead of the earnings curve.

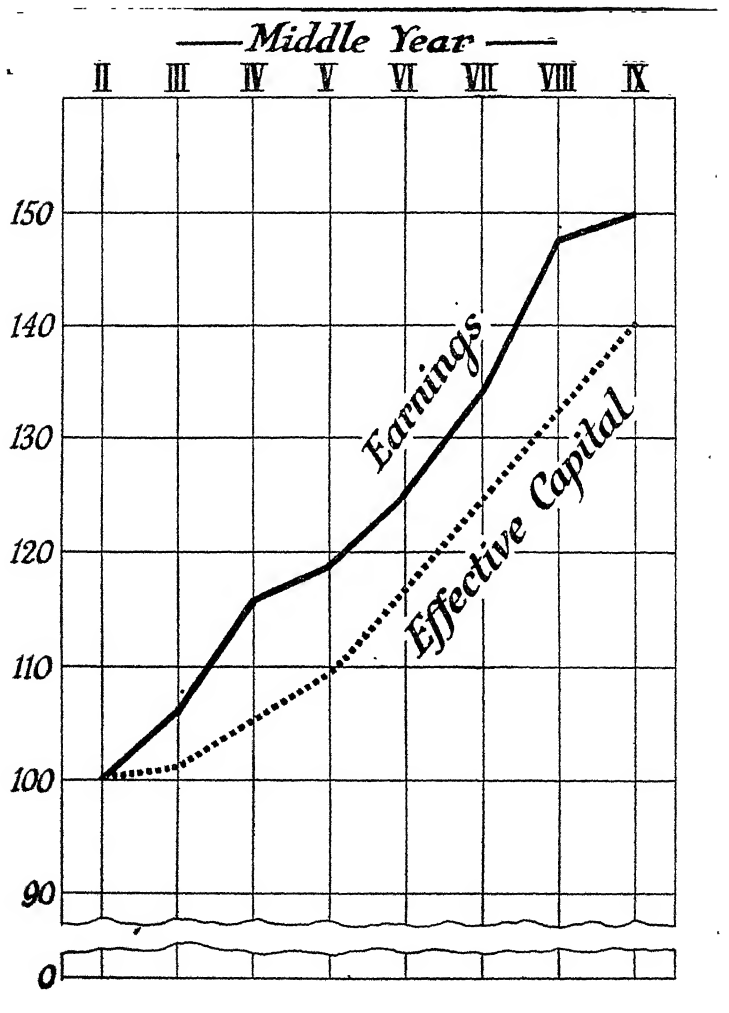
The very jaggedness of the line of earnings itself suggests that by taking any *single* year's results the investor may obtain a misleading impression. For example, the figure of 140, in Year V, was clearly too high an index of the company's average earning power *at that time*, while that of 118, in Year VI, was too low. In other words, had annual profits maintained a regular, instead of a fluctuating, movement, the figure for Year V would have been lower than 140, and that for Year VI higher than 118. Now the long-term investor, as such, is not concerned with short-term fluctuations, but with long-term trends. He can best view each year's results in its appropriate background, against those for the year which preceded and the year which succeeded it. For example, if the "trend of earnings" figure for Year II be regarded as the *average* for Years I, II and III, it will appear as £26,333, against an "actual" figure of £27,500. The "trend" figure for Year III will be the average of Years II, III and IV, i.e. £27,750, and the "trend" figure for Year IV, the average for Years III, IV and V . . . and so on. If the reader continues the process of calculation to the end of the series, he will then have a new series of eight figures, representing what are known as "three years' moving averages"—a term which is self-explanatory.

O.P. COMPANY, LIMITED—THREE YEARS' MOVING AVERAGES

Three Years, of which Middle Year is	Effective Ordinary Capital		Ordinary Earnings	
	£		£	
II . .	229,033	*100*	26,333	*100*
III . .	232,033	*101*	27,750	*105*
IV . .	239,783	*105*	30,250	*115*
V . .	250,033	*109*	31,250	*119*
VI . .	267,950	*117*	32,750	*124*
VII . .	284,033	*124*	35,000	*133*
VIII . .	302,367	*132*	39,000	*148*
IX . .	321,367	*140*	39,500	*150*

O.P. COMPANY LIMITED

THREE YEARS' MOVING AVERAGES



If he uses the first figure of this series as a new base (100) for his earnings curve, and recalculates the effective capital figures on the same lines, he will obtain the figures for a revised share chart which are shown at the foot of page 69.

A share chart based on these figures appears opposite. A comparison with the previous chart is instructive. When the *trend* of earnings is shown in juxtaposition with the *trend* of effective capital it is apparent that the company has vindicated the board's decision to finance an expansion of business "from within," since profits have risen more than in proportion to the increased capital resources.

Subject to the results of further tests, described in subsequent chapters, the Ordinary shares of this company appear, *prima facie*, attractive to the long-term investor, for several reasons. First, despite the kink in the earnings curve towards the end of its run, there is no evidence that further increments of effective capital will not be fully reflected in higher earnings. Consequently, if the directors continue their conservative dividend policy, an enhancement of the value of the Ordinary shareholders' equity may be looked for. Secondly, if it is to be inferred from the raising of the dividend from 10 to 15 per cent in Year X—a year when actual profits are "below the trend"—that the directors regard the need for large capital accretions as less insistent than a few years ago, and propose to pay higher dividends in future, then the investor can look forward to an increasing income, and a higher market price for his shares. Thirdly, purchases during periods when earnings are below the trend will afford the investor an opportunity of "getting in on the ground floor."

These examples serve to illustrate the *modus operandi* of simple share charts, and a few of the many useful deductions which may be drawn from them A number of more detailed measurements for Ordinary shares will be described in the next chapter.

CHAPTER VIII

ORDINARY SHARES—MORE DETAILED MEASUREMENTS

NON-measurable influences on share values—Dangers of empiric methods—Statistical analysis indispensable to sound judgment—Progressive, stagnant, and declining shares—Measurement of dynamic tendency, stability, directorial policy, and market capitalization.

THE charts described in the last chapter perform an indispensable service in introducing potential investors to the main characteristics of any Ordinary shares whose purchase they may be contemplating. No investor who has any respect for his pocket should expend money on a share without first ascertaining all that is to be learned from the relevant chart. Before one can claim real knowledge, however, as distinct from acquaintanceship, more extensive analysis is a *sine qua non*. Some essential facts cannot be deduced from any set of figures. Far-reaching trade fluctuations, currency developments, tariff modifications, changes of fashion, and many other imponderables may affect any given share. No cut-and-dried measurement system can replace intelligent interest in external affairs. The news service of the modern world is unequalled for promptitude, but investors must themselves fit its products to their own particular interests.

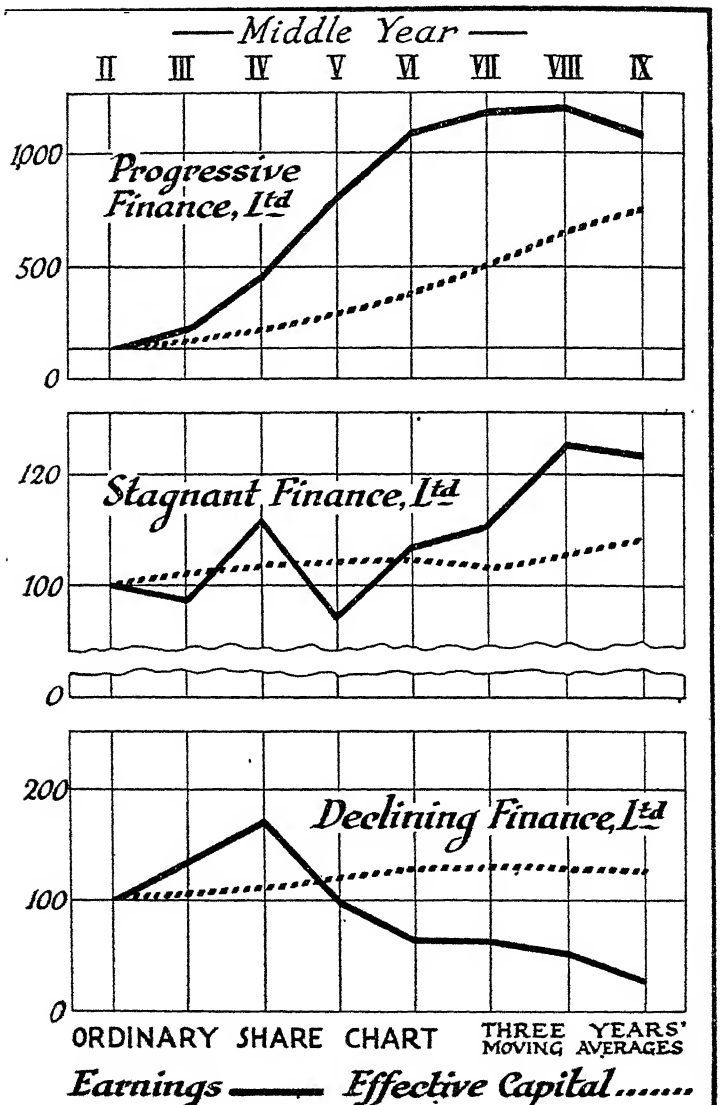
An investment, again, may change its value owing to developments unprinted and unprintable—a bad contract, a coming bid for control, a share issue to acquire a new subsidiary, a change of dividend, or the formation of a "shop" to work the market. Only a favoured few obtain advance information of these matters. There are times when a friend among the directors is worth more than an office full of charts.

But such empiric knowledge, however indispensable at times, may be useless, and even misleading, if it replaces

rather than supplements more systematic information. Pseudo-confidential reports, indeed, are the most effective weapon in the armoury of a certain type of share pusher. Stocks which no self-respecting capitalist would touch with a barge-pole may be rushed up on reports—which may be perfectly authentic—of a big manufacturing order. But a hundred such orders could not convert an inefficient, water-logged company into a profit-earner. One knows Hercules by his foot, and a company by its record. Ultimately, therefore, the measurement of results, in their appropriate historical background, is indispensable if a man wishes to keep his percentage of bad investments at a minimum.

A capital and earnings chart is designed, not to tell an investor all he ought to know, but to show him, at a glance, which shares are worth closer looking into, and which are not. The powers who decide the fate of applicants for posts, from a junior clerk to a borough treasurer, turn down the majority of candidates on their written credentials, reserving the more searching test of an interview for a select minority. Similarly, investors will be dismayed to discover how few of the Ordinary share propositions put up to them will survive even a cursory inspection of their past records. On the next page, for instance, are the share charts of three companies. The figures are not imaginary, the shares of the three concerns being, in fact, dealt in every day on the London Stock Exchange. Their names have been suppressed, partly because, although truth is mighty, the law of libel is mightier still, and partly in order that readers may not have their perceptions clouded by preconceptions. The three concerns have been dubbed, respectively, Progressive Finance, Ltd., Stagnant Finance, Ltd., and Declining Finance, Ltd., and the charts have been constructed on the lines described in preceding chapters, viz.:

(1) The "Ordinary earnings" and "effective Ordinary


—Middle Year—
II III IV V VI VII VIII IX
1000
500
0
Progressive Finance, Ltd
120
100
0
Stagnant Finance, Ltd
200
100
0
Declining Finance, Ltd
ORDINARY SHARE CHART
THREE YEARS' MOVING AVERAGES
Earnings
Effective Capital

capital" figures of the three companies have first been calculated over a period of ten years.

(2) To obtain a smooth curve, a "moving average" has been taken, the figures used for Year II being the arithmetical average for Years I, II and III, and those for Year III, the average for Years II to IV, *et seq.*

(3) The earliest figures (i.e. the Year II averages) in each case have been equated to 100, and the remainder re-expressed on the same basis.

The resulting figures are these—

Three Years' Averages, of which Middle Year is	Progressive Finance, Limited		Stagnant Finance, Limited		Declining Finance, Limited	
	Effective Ordinary Capital	Ordinary Earnings	Effective Ordinary Capital	Ordinary Earnings	Effective Ordinary Capital	Ordinary Earnings
II . .	100	100	100	100	100	100
III . .	122	225	101	97	103	137
IV . .	170	478	103	111	110	167
V . .	247	801	103	95	120	98
VI . .	346	1,090	104	106	123	60
VII . .	494	1,169	103	110	123	58
VIII . .	625	1,217	105	125	122	47
IX . .	722	1,096	107	123	121	25

For reasons of space, a different vertical scale has been used for the chart of each company, though the investor should, as far as possible, employ an identical scale for all his charts.

A brief inspection of the charts suggests a number of significant conclusions:

Progressive Finance. This company's extraordinarily swift rise in the earlier years strongly argues the existence of conditions which could not possibly have continued indefinitely. From Years II to VI every pound of new capital gave a rapidly increasing return. Subsequently, the pace of earnings fell off while capital continued to increase. The experienced investor will at once recognize the familiar story of a "pioneer" concern which has made enormous profits while occupying "virgin territory," but (as always happens)

has attracted numerous competitors into its field. Its bonanza period is now, probably, over, but its shares, nevertheless, are of sufficient interest to deserve closer investigation.

Stagnant Finance. Earnings have a pronounced tendency to annual fluctuation, which requires closer investigation. On the basis of the first few years, the company would have to be written down as entirely deserving its name. Subsequently, however, there has been a noteworthy increase in the yield per £ of capital employed, and the shares clearly warrant further inquiry.

Declining Finance. This is a company which obviously has some underlying weakness, the cause of which may lie either in its own organization or in the industry in which it operates. This is no temporary phenomenon—the trend of earnings has been downwards for the last five or six years. Life being short, the prudent investor will not waste any further time on this company. Its results will be referred to, later in this chapter, merely because they illustrate certain features on which it is desired to dwell.

For more detailed work, attention may first be concentrated on "Progressive Finance." The three-year average figures, on which the figures given for this company on page 75 are based, are these—

Three Years' Averages of which Middle Year is	Three Years' Moving Average	
	Capital	Earnings
	£	£
II	527	79
III	646	178
IV	897	378
V	1,301	633
VI	1,825	861
VII	2,604	924
VIII	3,295	962
IX	3,807	866

Having arrived at the moving averages shown above, the first question the investor should ask himself is: What is the average annual increase in the two sets of figures? In the next table, each of the "moving average" totals is compared with its predecessor in the series, and a third column shows the return on £100 of effective capital from period to period—

Middle Year	Percentage Increase (+) or Decrease (−) as Compared with Previous Average		Return in Earnings on £100 Effective Capital
	Effective Capital	Earnings	
	%	%	£
II . .	—	—	15·0
III . .	+ 22½	+ 125	27·6
IV . .	+ 39	+ 112	42·1
V . .	+ 45	+ 67½	48·7
VI . .	+ 40	+ 36	47·2
VII . .	+ 43	+ 7	35·5
VIII . .	+ 26½	+ 4	29·2
IX . .	+ 15½	− 10	22·7

This company's chart, it will be remembered, showed a phenomenally rapid rise in earnings for more than half the period covered (the pace of which, it was suggested, was too hot to last) and a decided check to expansion subsequently.

The above table adds a good deal to this preliminary impression. It suggests: (1) That the period of very high annual earnings per £100 of capital is over. Earnings have had a "cycle" of their own, with a regular "upswing" and a decline to somewhere near the original level. This "cycle" is still in progress. (2) Even while the earnings per £100 of capital were rising, the *average rate of increase was slackening* each year, at a time when the average rate of increase of capital (i.e. the "pace" at which new capital was introduced) was being expedited.

This company, clearly, has not yet shown what its *stable* long-term ratio of earning power is likely to be. Its Ordinary

shares may be a promising investment, but a cautious investor will not buy them until the company has completed the downward stage of its "cycle," and the return on its capital has ceased to decline.

The next point to be investigated is the relative stability of earnings from period to period. The preceding analyses have laid strong emphasis on the *dynamic* aspect of capital and earnings movements. Readers have been advised to base their policy, not on short-period fluctuations, but on long-term trends. In practice, however, fluctuations from the trend may have an intimate bearing on the choice of the moment for buying a share. There are some companies, as already pointed out, whose profits are remarkably steady from year to year, and others whose annual earnings fluctuate remarkably, either as a result of special internal circumstances or, more frequently, of conditions in the industry in which they work.

The investor who has satisfied himself that there is a reasonable possibility that the future trend of a share will be upward, can, in such a case, make an advantageous purchase by getting in at the bottom of an intermediate fluctuation. The market frequently bases its judgment mainly on what has happened in the latest year. The careful investor, however, may very well discover that the deviation in that year is no more than should be regarded as normal for the company. He will, therefore, rightly conclude that the intrinsic security of the share has not been affected. Conversely, he will be on his guard if he sees more than a customary downward fluctuation.

How can this "susceptibility to fluctuation" best be measured? Clearly, what one requires to know is the distance between the point at which earnings actually stand, at any given moment, and the corresponding point on their smoothed-out trend curve. A convenient way of obtaining a result sufficiently satisfactory for most purposes, without

complicated mathematical formulæ, can be illustrated from the following table, based on the figures for "Stagnant Finance, Ltd."—

(000's *omitted*)

Year	Effective Ordinary Capital	Total Ordinary Earnings	Three Years' Moving Average		Deviation—Middle Year's Earnings from Three Years' Average
			Capital	Earnings	
	£	£	£	£	£
I .	16,664	2,762	—	—	—
II .	17,024	1,742	16,897	2,482	740
III .	17,003	2,941	17,075	2,414	527
IV .	17,199	2,560	17,382	2,759	199
V .	17,943	2,777	17,399	2,344	433
VI .	17,056	1,695	17,548	2,624	929
VII .	17,645	3,400	17,498	2,731	669
VIII .	17,794	3,099	17,834	3,116	17
IX .	18,063	2,850	18,141	3,000	150
X .	18,567	3,051	—	—	—

This company, it may be recalled, appeared unprogressive in the earlier years of the decade, but subsequently shot ahead. The actual yearly earnings figures, however, fluctuated in remarkable fashion, being as low as £1,695,000 in one year, and as high as £3,400,000 in the next. The last column shows the difference between the actual earnings for any one year, and the average for the three years of which it was the central period. For example, the average for Years I, II, and III, was £2,482,000, while actual earnings for Year II (the middle year), were £1,742,000. Thus the "deviation" from the average was £2,482,000 *minus* £1,742,000, i.e. £740,000. Whether the result is a *plus* or *minus* quantity does not matter for this particular purpose.

The calculation is completed as follows: (1) All the figures in the "deviation" column are added. (2) The "deviation" total is then expressed as a percentage of the moving "earnings" total. The sum of the figures in the moving average earnings column, in this case, is £21,470, and the sum of those

in the "deviation" column £3,664. The latter as a percentage of the former (i.e. the "deviation percentage") is 17·1 per cent.

This shows what may be called the "average liability to fluctuation" of the share. Investors who have made this calculation will not, in future, be unduly alarmed unless the actual profits in any year show a decline of considerably more than 17 per cent from the last average: nor will they be elated at a future rise of not much more than 17 per cent.

The relative stability of profits varies far more, as between different companies, than is generally realized. For instance, the "deviation percentage" of Progressive Finance, Ltd. is no more than 10.1 per cent. A drop of 15 per cent in the profits of this company would, therefore, be a more ominous sign than one of 20 per cent in the case of the company given above.

The next quality to be measured (by its fruits) is directorial conservatism. Of each year's earnings, how much is going out of the business, and how much is being retained? The distinction is on all-fours with that between spending and saving in the case of an individual. Dividends—so far as a company is concerned—are gone beyond recall. Amounts retained, however, are additions to effective capital, on which a company (regrettably) pays income-tax, but (happily) no capital duties—unless and until, by a purely book-keeping transaction, it calls them bonus shares instead of reserves.

It is obviously expedient to keep a close watch on policy in this respect. It is not what a company does in one year, but its action over a period of years which chiefly matters. Hence the comparison should be based on *absolute amounts*, in money, rather than on *percentages* of each year's profits (which involve a change of base every year), or of paid-up capital.

The following table shows a simple method of setting out

the necessary facts. The figures show the appropriation of earnings of two companies—"Progressive Finance Ltd.," and "Declining Finance Ltd.,"—

(000's *omitted*)

Year	Progressive Finance, Ltd.		Declining Finance, Ltd.	
	Paid in Dividends	Retained in the Business	Paid in Dividends	Retained in the Business
	£	£	£	£
I .	30	19	125	*– 49*
II .	38	34	125	*– 49*
III .	80	35	250	299
IV .	127	221	200	140
V .	240	431	135	147
VI .	320	559	150	*– 85*
VII .	450	582	150	*– 77*
VIII .	562	298	150	121
IX .	703	291	100	*– 111*
X .	687	48	Nil	*– 82*

The figures are extremely significant. They show at a glance, for instance, that although Progressive Finance has evidently had a conservative board of directors, who have ploughed back a good deal of money into the business, in recent years the directors have been dividing more and retaining less of available profits. Declining Finance is a divider of profits up to, and over, the hilt. In six of the ten years it has taken money *out* of its business in order to pay dividends.

In the above discussion of "stability," it was suggested that a favourable opportunity might occur of buying a share with a high deviation percentage when the market had put down its price on a purely "normal" downward fluctuation of profits. The question of market prices can never be ignored, since the investor can obtain a "seasoned" share only at the figure at which some one else is prepared to sell, which may vary considerably from time to time. Caution is necessary lest a good share be purchased at a "bad" price. How can this question be dealt with, numerically?

The most convenient method is suggested by the next table.

DECLINING FINANCE, LIMITED

Year	Paid-up Ordinary Capital (Nominal Value)	Mean Market Price £1 Shares	Mean Market Capitalization	Total Ordinary Earnings	Ordinary Earnings per £100 of Market Capitalization
	(£000)	*s. d.*	(£000)	(£000)	£
I .	2,011	17 7	1,768	76	4·3
II .	2,011	19 4	1,944	76	3·9
III .	2,011	26 7	2,673	549	20·5
IV .	2,011	34 10	3,502	340	9·7
V .	2,011	35 7	3,578	282	7·9
VI .	2,011	31 7	3,176	65	2·0
VII .	2,011	27 –	2,715	73	2·7
VIII .	2,011	28 8	2,882	271	9·4
IX .	2,011	21 6	2,162	*Dr. 11*	*Dr. 0·5*
X .	2,011	11 11	1,198	*Dr. 82*	*Dr. 6·8*

The method is as follows: (1) Set out the *paid-up* Ordinary capital (*not* the effective capital) for each year. (2) Take the mean market price for the shares during the year in question. Thus, if market quotations for Declining Finance £1 Ordinary, in Year I, fluctuated between a high point of 22s. 9d. and a low point of 12s. 5d., the mean price was 17s. 7d. (i.e. $\frac{22\text{s. } 9\text{d.} + 12\text{s. } 5\text{d.}}{2}$). (3) Ascertain the "market capitalization" at this mean figure—in other words, the value of the total paid-up capital at the average market quotation. In Year I, for example, the above company had 2,011,000 shares valued at 17s. 7d., its total market capitalization thus being £1,768,000. (4) Express the actual earnings of each year as a percentage of the market capitalization. A "smooth" result can, finally, be obtained by taking three years' moving averages of market capitalization and earnings.

An investor considering the purchase of any particular share can readily work out the market capitalization at the

price of the day, and see how the indicated earnings' yield per £100 (on the basis of the last available figures) fits in with the general impression given by the earlier figures. The rule is, of course, that the larger the indicated earnings per £100 market capitalization, the "cheaper" the investment, other things being equal.

The detailed measurements, so far considered, have covered earnings and capital trends, stability and deviation, directorial policy, and market value. A final consideration —that of "gearing"—is of sufficient importance to merit treatment in a separate chapter.

CHAPTER IX

"GEAR RATIO" OF ORDINARY SHARES

PROPORTION between prior charges and ordinary capital—Effect of "gearing" on share earnings, dividends and market value—Examples from British industry—"Gear ratio" of holding companies—How to measure "gearing."

INVESTORS and their advisers, after making a close analysis of a particular share, frequently lose money or opportunities, or both, by failure to remember that the relevant factors in the equation include not only earnings and effective capital, but also the "gear ratio." An investment, like a motor-car, is not a static but a dynamic object. The most shining bodywork, and even a sound engine, are no guarantee of good road performance unless the "gearing" is well adapted to the purpose in view.

If readers will allow themselves to be transported in imagination back to the (alleged) happiest days of their lives, a few blackboard figures will illustrate the importance of the principle. Let there be three well-known and prosperous companies, each with £1,000,000 of paid-up capital,

CAPITALIZATION

	Thin Equity Ltd.	Fat Equity Ltd.	All Equity Ltd.
Total Capital	£ 1,000,000	£ 1,000,000	£ 1,000,000
5½% First Mort. Debentures, £1 .	375,000	125,000	—
6½% Cum. Preference Shares, £1 .	375,000	125,000	—
Total Fixed-interest Capital . .	750,000	250,000	—
Ordinary Shares, £1 . . .	250,000	750,000	1,000,000
"Gear Ratio" [1]	*0·33 to 1*	*3 to 1*	*"Infinite"*

[1] i.e. Amount of Ordinary Capital per £1 of Fixed-interest Capital.

and let the first have one quarter, the second three-quarters, and the third the whole of its capital in the form of Ordinary shares. Dubbing the trio, respectively, Thin Equity, Ltd., Fat Equity, Ltd., and All Equity, Ltd., we have capitalization as shown in the table at the bottom of page 84.

Let it be further presumed that, in a good year, each company earned 15 per cent on its total paid-up capital. From the point of view of *aggregate* earning power, the position of all three was identical, but, thanks to their different "gear ratios," an investment in their Ordinary shares gave strikingly different results. Presuming, for simplicity's sake, that all three lapsed from grace by paying out profits up to the hilt, the following results would have been shown—

PROFITS AND DIVIDENDS IN A GOOD YEAR

	Thin Equity Ltd.	Fat Equity Ltd.	All Equity Ltd.
	£	£	£
Total Profits	150,000	150,000	150,000
Debenture Interest	20,625	6,875	—
Preference Dividend	24,375	8,125	—
Total Fixed-interest Payments	45,000	15,000	—
Available for Ordinary shares	105,000	135,000	150,000
Ordinary Dividend	42%	18%	15%

Presuming that the investor, in this particular industry, looked for a yield of, say, 7 per cent from an Ordinary share, the market value of the £1 Ordinary shares, on the publication of the reports, would have been: Thin Equity, 6; Fat Equity, $2\frac{9}{16}$; All Equity, $2\frac{5}{32}$.

Next year, unfortunately, all three concerns meet industrial depression, and their earnings decline to 10 per cent

of their total capital. The dividends they are now in a position to pay are—

PROFITS AND DIVIDENDS IN A MORE DEPRESSED YEAR

	Thin Equity Ltd.	Fat Equity Ltd.	All Equity Ltd.
	£	£	£
Total Profits	100,000	100,000	100,000
Total Preferential Payments (as before)	45,000	15,000	—
Available for Ordinary shares .	55,000	85,000	100,000
Ordinary Dividend . . .	22%	11·3%	10%

Depression, it will be seen, has affected all the companies equally, the earnings available for the Ordinary shares showing an identical falling off (£50,000) in each case. Thin Equity shareholders, however, suffer the greatest and All Equity shareholders the smallest *proportionate* reduction of dividends.

On a 7 per cent yield basis, the respective market values will now be: Thin Equity $3\frac{5}{32}$, Fat Equity $1\frac{5}{8}$, All Equity $1\frac{7}{16}$. *Investors who bought the shares at the top have lost* $47\frac{1}{2}$ *per cent of the capital value of their investment in the first case,* $36\frac{1}{2}$ *per cent in the second, and only* $33\frac{1}{4}$ *per cent in the third. But in the preceding "boom," Thin Equity naturally attracted the largest number of investors and All Equity the least.*

The differing results of these three cases are due entirely to divergent "gear ratios." It is highly desirable that those who are responsible for putting investors into particular stocks should take this factor seriously into account. Broadly speaking, the higher the proportion of preferential capital to total capital, the more speculative the Ordinary shares. The rule for shares is the same as that for cars: the high-geared share (i.e. the share with a high proportion of fixed-

interest capital in front of it) gives the fastest running when the going is good, but the low-geared share is the best hill-climber in difficult times.

For practical purposes, the investor's best policy is to sell high-geared shares as soon as profits and quotations begin to fall. Other things being equal, such shares will show the heaviest drop before touching bottom. On the other hand, when industry has taken the turn and increasing profits are forecast, high-geared shares will show the largest appreciation in value.

To bring these doctrines down from air to earth, we may set out the gear ratio of some large British companies, whose shares are, as a rule, active in the market. The relevant figures, at the time this book was written, were these—

Company	Total Fixed-Interest Capital	Total Ordinary Capital	*"Gear Ratio"*[1]
	£	£	
Amalgamated Anthracite .	5,464,821	6,717,300	*1·2 to 1*
Associated Electrical .	2,269,403	3,498,900	*1·5 to 1*
British Match . . .	525,000	6,187,500	*11·8 to 1*
Cables and Wireless . .	43,598,729[2]	8,588,569	*0·2 to 1*
Gaumont British . .	2,050,000	2,500,000	*1·2 to 1*
Imperial Chemical . .	22,100,012	54,381,747	*2·5 to 1*
Unilever Ltd. . . .	2,100,000	11,418,750	*5·4 to 1*
Turner & Newall . .	1,442,436	3,381,505	*2·3 to 1*
Great Western Railway .	104,446,974	42,928,737	*0·4 to 1*
L.M.S. Railway . .	318,576,416	95,202,441	*0·3 to 1*

[1] i.e. Amount of Ordinary Capital per £1 of Fixed-interest Capital.
[2] Including "A" Ordinary shares.

Even this short list shows that gear ratios, in practice, vary enormously, from the unusually low gear of British Match to the decidedly high gear of the two railways.

The investor, for practical purposes, may regard a ratio of less than 1 to 1 as high, up to 2 to 1 as moderate, and over 2 to 1 as relatively low. The proportions are *inverse*, for reasons which car drivers will readily appreciate.

Among the stocks shown in the table, the high gearing of the railways is conspicuous. The results of this condition were made evident in a recent depression, when the Stock Exchange quotation for the Ordinary shares of a large railway fell from 77 to 49 in the course of a single year—and subsequently declined to 13.

Into the "moderate" group fall the Ordinary shares of Amalgamated Anthracite, Associated Electrical and Gaumont British. The low-geared stocks—on a first inspection—include Turner and Newall Ordinary, Imperial Chemical (Ordinary and Deferred), Unilever Ltd., and British Match. All these companies, however, are "holding" concerns, and investors, in these cases, must look further than the capitalization of the companies themselves. Most holding concerns acquire control of subsidiaries by purchasing a majority interest in their Ordinary shares. The real "gear ratio" *of the combine* in such a case is higher than appears on paper.

How far this process may go is revealed by the capital structure, for instance, of a well-known holding company in the drapery business. Company D, the parent concern, depends for its income on the Ordinary capital of Subsidiary X (which has £7,983,000 of Preferential capital in front of it). The largest investment of Subsidiary X is in the Ordinary capital of Subsidiary Y, which, in its turn, holds Ordinary shares in a large number of businesses, Subsidiaries Z_1, Z_2, Z_3, Z_4. . . . As a result, the gear ratio of the parent company, which on paper appears to be 0·5 to 1, is really more like 0·05 to 1. The investor must expect wide fluctuations in the earnings and dividends of Company D, the parent concern, as a matter of course.

There is another point of which investors in high-geared Ordinary shares should take note. As Debentures and Preference shares rarely, in this country, have voting powers, it is much easier for an outside interest to obtain

majority control of a concern with a small than of one with a large Ordinary capital. Many investors, rightly or wrongly, prefer a holding in a moderate-sized business, with whose policy and methods they are familiar, to a share in a vast combine, which is more subject to "market" and other outside influences. Such investors would do well to avoid high-geared shares, the rule being: *the higher the gearing, the greater the "risk" of absorption.*

When the "gearing" of a share is being examined over a series of years, the measurement can best be made in terms of earnings, not of paid-up capital. The latter is open to certain objections which have been discussed earlier in this book. The necessary procedure is simple. Side by side with a ten years' series of Ordinary earnings are set out the total Debenture and Preference payments for the same years. The gear ratio is the amount of Ordinary earnings per £100 of prior payments.

For example, if this method is applied to Progressive Finance, Ltd., and Declining Finance, Ltd., the following are the results—

Year	Progressive Finance, Limited			Declining Finance, Limited		
	Total Prior and Preferential Payments	Total Ordinary Earnings	*Ordinary Earnings per £100 of Prior Payments*	Total Prior and Preferential Payments	Total Ordinary Earnings	*Ordinary Earnings per £100 of Prior Payments*
	£000	*£000*	*£*	*£000*	*£000*	*£*
I .	20	49	*245*	279	76	*27*
II .	20	72	*360*	279	76	*27*
III .	20	115	*575*	279	549	*197*
IV .	20	348	*1,740*	279	340	*122*
V .	20	671	*3,355*	279	282	*101*
VI .	20	879	*4,395*	279	65	*23*
VII .	20	1,032	*5,160*	279	73	*26*
VIII .	20	860	*4,300*	279	271	*97*
IX .	20	994	*4,970*	279	*Dr. 11*	*- 4*
X .	20	735	*3,675*	279	*Dr. 82*	*- 29*

These figures show how greatly "effective gearing" may change within quite a few years—or even within a single year if earnings are liable to widespread fluctuation—while

the "nominal gearing" remains unaltered. Broadly speaking, a company with less than £200 of Ordinary earnings per £100 of prior payments may be classed as "high-geared"; a company with £200 to £400 as "medium-geared"; and one with over £400 as "low-geared." The table shows that Progressive Finance is very low-geared and Declining Finance very high-geared—so much so that the latter company has not entirely covered its prior payments in the last two years shown. The question is, of course, of interest also from the viewpoint of holders of prior charges. A Debenture or Preference share in a low-geared company, in the majority of cases, is a safer security than its counterpart in a high-geared concern. The more "junior" the security, the more important the question of gearing.

Gearing, again, has an intimate connection with the question of stability of Ordinary share earnings, which was discussed in the preceding chapter. From what has been said above, it is evident that, other things being equal, Ordinary earnings on a high-geared share are liable to fluctuate much more considerably than those on a low-geared share. When susceptibility to trade fluctuation and high-gearing are combined in the same share, the jolts and jars of annual fluctuations may be considerable and painful—as railway stockholders discovered to their cost, in the years of depressed earnings and road competition after the Great War. On the other hand, when the going is good, the earnings on a high-geared share may rise in exhilarating fashion.

Some of the observations made in the course of this chapter may, in conclusion, be conveniently summarized—

(1) The higher the gearing (i.e. the lower the proportion of Ordinary earnings to prior payments), the more speculative the share, as a rule.

(2) The advantages of high-gearing are in direct proportion to the "steepness" of the trend of earnings. They are at their maximum when the trend is rapidly rising. Every

sharp fall in the trend, on the other hand, emphasizes the disadvantages of high-gearing.

(3) If earnings show a relatively flat trend, low-geared shares are safer than high-geared.

(4) When the trade of a country is recovering after depression, the market prices of high-geared shares will rise more quickly than those of low-geared shares. When trade is declining, investors may limit their capital losses by switching from high-geared to low-geared shares.

CHAPTER X

ORDINARY SHARES—RECAPITULATION

METHOD of measuring trend, fluctuation, gearing, profit appropriation policy and market value—Specimen set of measurements.—Purpose of Ordinary share measurement—Dangers of existing methods—Conclusions.

IN the course of the last five chapters, a detailed series of "measurements" for Ordinary shares has been set out and discussed, step by step. Before leaving the subject of Ordinary share measurement, it may be useful briefly to summarize and to recapitulate the different methods which have been suggested, and to illustrate them by a complete set of figures, based on the accounts of a large British company.

The *modus operandi* as regards any given share is as follows. At least ten years' results are taken, the figures being subsequently extended as further returns become available. The "effective Ordinary capital" for the first year is ascertained by adding to paid-up Ordinary capital (at the beginning of that year) the balance-sheet total of visible "general" reserves, including the "carry forward." Subsequent figures are obtained by adding the *money* brought in by new issues of capital, *plus* Ordinary earnings not paid out as dividends. Side by side with these figures are set out the total "Ordinary earnings" of each year—the latter being defined as earnings accruing to the account of Ordinary shareholders, after all expenses and prior payments (including depreciation) have been met.

The investor now has two series of figures which may be treated by simple statistical methods, to throw light on a number of crucial questions.

(1) *Trend.* To ascertain the trend of a share, the two series of figures mentioned above should be set out in three-year moving averages. If the first of these averages in each

case be then equated to 100, and the remaining numerals re-expressed on this basis, the investor has the material for an instructive chart. This will tell him more at a glance than he would obtain by the majority of existing methods in a week.

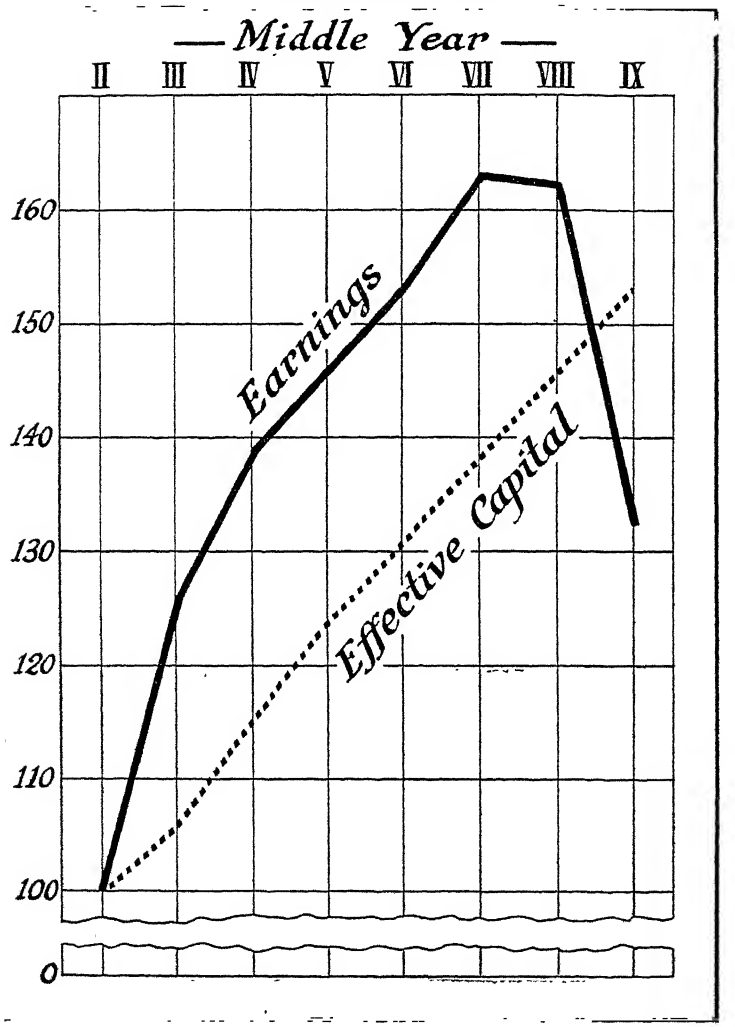
The investor should then take the three years' average figures, and see what percentage increase or decrease is shown by each year's figure (for both capital and earnings), on the basis of the previous figure in the series. Finally, it is a simple matter to work out the return, in earnings, on £100 of effective capital for each year.

(2) *Fluctuation.* It is important for the investor to know not merely what is the trend of the share, but whether its annual fluctuations on either side of the trend are extensive or the reverse. To obtain this information, the actual earnings for each year should be compared with the average earnings for the three years of which it forms the centre. The sum total of these "deviations" expressed as a percentage of the total of *all* the earnings in the moving average, is the "deviation percentage" for the whole period. This is a most useful yardstick for measuring the significance of *future* fluctuations in profits.

(3) *Gearing.* Closely akin to the question of fluctuation is that of the "gear ratio." This expresses the relation of fixed charges to Ordinary share earnings. When the proportion of fixed charges is high, the shares are "high-geared." A high-geared Ordinary share is far more susceptible to extreme fluctuations in earnings than a low-geared share. The gear ratio may be ascertained by setting out the total prior payments each year, and showing the Ordinary earnings available per £100 of these prior payments.

(4) *Profit Appropriation Policy.* A company's future prospects may depend not merely on its trading experience, but also on its dividend policy. Earnings paid out in dividends are "spent," and earnings retained in the business

MODERN MATERIALS, LIMITED



"saved" and added to effective capital. The amounts distributed and retained should be set out, respectively, year by year, in parallel columns.

(5) *Market Value.* These results may, finally, be related to market conditions by calculating the "ordinary market capitalization" of a given share at the middle price of each year, reducing the results to three-year averages, and showing actual earnings per £100 of market capitalization. Broadly, the higher the earnings on this basis, the better the time to buy an Ordinary share which appears attractive by every other test.

The table and chart relating to Modern Materials, Limited, show the results obtained by the application of these methods to a ten-year period in the business life of a large company, whose Ordinary shares are among the most active industrial equities in the British market. No comments are offered, readers being invited rather to make a careful study of the figures, and to see what conclusions are suggested in their own minds. They will find, doubtless, that the compilation of similar figures for other shares may be a matter of several hours' labour. It is worth while, however, to expend a fair amount of time or trouble before investing one's money in any security. The avoidance of a single bad investment may be a more than ample repayment for the task of constructing a dozen detailed tables.

Measurement in investment, as in many other "sciences," is an essential preliminary to sound judgment. Improvements in methods of measurement are generally followed by definite advances in knowledge, for it is measurement which provides the scientific craftsman with his tools.

At least two objections can be made to the results obtained by methods in vogue to-day.

(1) They are frequently based on only one or two years' figures. Before deciding to build a house in a new locality, it is not enough to know what the climate was like in the

preceding week; one must have knowledge of its characteristics under all possible conditions.

(2) A misleading basis of comparison is taken, viz., earnings on paid-up capital at the latter's nominal value. What the investor really wishes to know is the earning power of the capital actually employed in the business. To this, nominal capital, which is purely a book-keeping convention, has no direct relation. An issue of bonus shares changes the paid-up capital without adding one penny to the earning capital in the business.

As regards (1), above, the investor who wishes to familiarize himself with the essential features of any Ordinary share *must* study its behaviour over a fairly long period. His object is to discover the company's reaction to all past changes, from within or without, which, *mutatis mutandis*, may again affect it in the future. For example, a rapid rise in earnings may be due to an arbitrary change in public taste, which may be purely ephemeral; to a widening of the market, as a result of the industrial evolution or a new invention which has brought within the buying power of "the masses" some product formerly limited to "the classes"; to profitable encroachment by some "interloper" on a territory formerly the preserve of a semi-monopolist combine; to exceptionally good management; or to many other causes. Some of these causes are, by their very nature, less permanent than others. Examples of each have been provided in profusion during the history of British public companies. All too frequently the "equity" of Ordinary shares has been written-up to a high value in the market, when a reasonably close examination of the facts would have shown that the underlying causes of high earnings were ephemeral.

For instance, figures have been given, in the course of the present discussion, relating to an existent British company, under the pseudonym Progressive Finance, Limited.

This concern recorded a phenomenal increase in earnings while it had a virgin field to conquer, but suffered a rapid decline in its earning power per £100 of effectively employed capital, as soon as it encountered more permanent conditions. From the investor's point of view, this all-important phenomenon was obscured, under existing methods of computation, by the fact that the company was annually placing large amounts to effective capital by way of reserves, which were accumulating at compound interest each year.

The methods which have been suggested have, without exception, one merit—they can be applied without elaborate mathematical knowledge. In all further developments there are two guiding principles to be kept in mind. First, the security for Ordinary shares is dynamic, not static. Secondly, the trend of earning power, in terms of capital employed, is the only permanent criterion of a share's attractiveness.

Investors must realize, however, that no cut-and-dried system of measurement possesses all the inevitable attributes of perfection, or can be a permanent substitute for adequate observation and common sense. The facts of company life are too varied to fit any rigid mould. In applying the figures resulting from the application of the methods suggested in preceding chapters to the results of any particular company, the investor may have due regard to three special considerations which may affect the completeness of the picture they represent. The first is the impossibility of discovering how far earned profits have, in fact, been reduced by allocations to "secret reserves" (see page 123), or swollen by accretions from such reserves, *before* disclosure of the balance to shareholders. So long as the amounts put away or withdrawn are not considerable, and tend, over a period of years, to cancel out each other, the trend of the Ordinary share tables will not be seriously affected. The disturbing influence, however, may be considerable in periods when profits are fluctuating violently, or when uncertainty over matters like taxation

weighs heavily with directors. Whenever these two factors are operative simultaneously—as they were, for instance, after the War, and again in the depression of the nineteen-thirties—investors should always be prepared to make generous mental allowance for their consequences. One of the largest British shipping companies was shown to have brought into its profits, for years after the War, the earnings of a boom period, by way of taxation refunds etc. The company whose figures are inset on page 94 of this book, again, will be found to have doubled its nominal Ordinary capital in Year VIII, by the capitalization of £12,000,000 taken partly from undisclosed reserves.

A second proviso concerns temporary additions to effective capital by way of changes in the amount of credit extended to, or granted by, a company whose results are under examination. No concern should normally regard loans from the bank as part of its permanent capital. While such loans are outstanding, however, they represent an indubitable addition to a company's working resources. Suppliers of materials, again, who allow a company extended credit, *pro tanto* increase its working capital. Conversely, the credit allowed by a company to its trade debtors, or its subsidiaries, ties up a certain proportion of its funds. The investor can make some allowance for variations in these "current" items by ascertaining "surplus liquid assets" at the date of each year's balance sheet, as suggested in Chapter XII. He can have no assurance, however, that some of the items have not varied very widely in the twelve months between one set of accounts and the next. He may even suspect a certain amount of "window dressing," carried out in order that each year's accounts may, at one and the same time, make the most impressive showing possible, and satisfy the vanity of their compilers.

Finally, it is possible that £1 "ploughed back" into the business may have a different "real" value at different

times. According to the calculations of the Board of Trade, £100 at the end of 1932 would have purchased as much, in the way of wholesale commodities, as £135 three years earlier. It is as well that such extreme changes are infrequent, for they are productive of economic crises affecting the lives and fortunes of millions of people. Whenever they occur, however, investors may find it necessary to adjust their computations of "profits ploughed back" by reference to their *real* rather than their purely *monetary* value. It is possible to compute changes in the Board of Trade index number of British wholesale prices—which is published regularly every month—over the exact period covered by the report of any one company. The results, however, will never correspond exactly with the true state of affairs, for companies do not use their accretions of effective capital to buy a mixed bag of wholesale commodities, but to install new machinery, purchase raw materials of specialized character, etc. In default of a series of specially constructed "price correctors" for every single company—which will never be obtainable—investors may tentatively apply the Board of Trade index, correct to the nearest 5 per cent. They should regard this, however, as a rough and ready method, which is just one degree better than no correction at all.

CHAPTER XI

"PRIORITY PERCENTAGES"

"COVER" for fixed-interest stocks—A common error—Calculation and utility of priority percentages—Priority tables: an example—Some maxims for Debenture and Preference holders—Construction of priority charts.

BEFORE leaving the subject of share measurement, the investor may consider another device which is, strictly speaking, of greater practical utility to holders of Debentures and Preference shares than to Ordinary shareholders. The "security" for all holders of fixed-interest stocks has already been described as the extent to which their annual interest and dividend requirements are covered by earnings. Most financial journalists, stockbrokers, and other investment specialists usually express this "cover" by the ratio $\frac{\text{Earnings Available}}{\text{Interest or Dividend}}$, so that if a company with £3,000,000 of 7 per cent Preference shares, entitled to an annual dividend of £210,000, shows net earnings of £840,000, the requirements of the Preference shares are said to be covered four times (since $\frac{840{,}000}{210{,}000} = 4$).

There is no fundamental objection to this method, provided it is rightly applied. In many cases, however, it is misused, and yields misleading results. For example, suppose a company has the following capital—

	£
4% Debentures	10,179,000
5% Cumulative Preference Shares	735,000
Ordinary Shares	15,000,000
Total	£25,914,000

In Year X, the company earns £1,717,500. How many times is the interest on the Debentures and Preference shares

"covered"? The 4 per cent Debentures require £407,160 in interest annually. This amount is covered, in Year X, some 4·2 times, $\left(\frac{1,717,500}{407,160} = 4.2\right)$. So far, so good. What is the "cover" for the 5 per cent Cumulative Preference shares? The answer frequently given depends on the calculation that, after the interest on the 4 per cent Debentures has been paid, some £1,310,340 of earnings remain as a reservoir out of which the 5 per cent Preference dividend can be drawn. Since the latter requires £36,750 annually, it appears to be covered 35·6 times $\left(\frac{1,310,340}{36,750} = 35.6\right)$. The inference, obviously, is that the 5 per cent Preference shares are far better covered than the 4 per cent Debentures —about 8½ times better covered, in fact. But this is absurd, seeing that they are the junior of the two securities. If the company's earnings fell, in a bad year, to only £407,160, there would not be a penny to pay the Preference shareholders, while the Debentures would earn, and receive, their full year's interest.

This "method" of computation involves a subtle fallacy. It overlooks the fact that the company, in order to pay a full year's interest on its 5 per cent Preference shares, must actually earn, not £36,750 but £443,910 (i.e. £407,160 *plus* £36,750). In other words, it must completely cover its Debenture interest before it can begin to think about paying a dividend on its Preference shares. It actually has available, in Year X, some £1,717,500 for both stocks. Its Preference dividend is therefore covered 3·9 times $\left(\frac{1,717,500}{443,910} = 3.9\right)$. Thus, the Preference shares are slightly inferior, as regards security for income, to the Debentures, whose interest is covered 4·2 times. In short, fixed-interest requirements must be taken *cumulatively*, in all "cover" calculations.

The "Priority Percentage" method, which has been adopted with success by certain professional investment "services," both in America and Great Britain, is, in essence, a particularly graphic method of presenting the results of the "cover" method. Its object is to show how each year's profits are shared out in due order among those who have the right to them. The First Debenture-holders, as it were, embark on the earnings bus, travel as far as their fixed dividend entitles them, and get off again. Their place is taken by the Second Debenture-holders, if any, who, having been carried for their appropriate distance, alight in turn to make way for the Preference shareholders. These, in due course, give place to the Ordinary proprietors, who have the right, if they choose, to stay on the bus until the end of its journey. Actually, they may travel only part of their journey, and leave the rest standing to their credit, as a "Reserve." The "Priority Percentage" method first equates each year's profits to 100, and then shows where each class of holder boards and alights from the bus.

In the example given above, the year's earnings are £1,717,500, of which the Debenture-holders are entitled to the first £407,160, the Preference shareholders (after the declaration of their dividend) to the next £36,750, and the Ordinary shareholders to the remaining £1,273,590. Suppose the company pays an Ordinary dividend of 7½ per cent, absorbing £1,125,000, and allocates the remaining £148,590 of profits to General Reserve and Carry Forward. A simple calculation will show that if the year's profits are represented by 100 per cent, Debenture interest requirements, starting from 0 per cent, will extend to 23½ per cent of the total. Preference dividends will start at 23½ and finish at 26. Ordinary dividends will begin at 26, and end at 91½. Reserves and Carry Forward will extend from 91½ to 100.

Suppose, however, that in the following year the company is slightly less successful, its earnings falling from £1,717,500

to £1,510,000. Its dividends, however, are unchanged, some £52,910 being taken from Reserves and Carry Forward to make up the full 7½ per cent Ordinary payment. The "Priority Percentages" for the two years will then appear as follows—

	First Year	Second Year
Total Earnings	£1,717,500	£1,510,000
"Priority Percentages"—	%	%
4% Debentures	0 to 23½	0 to 27
5% Preference Shares	23½ to 26	27 to 29½
Ordinary Shares	26 to 91½	29½ to 104
Reserve and "Carry Forward"	91½ to 100	104 to 100
Ordinary Dividend Rate	7½%	7½%

The effect of the drop in the second year's profits, on all classes of capital, can be readily perceived. In the first year, the Debentures, requiring only 23½ per cent of total earnings, were "backed" by a further 76½ per cent of profits. In the second year, their interest (which was, of course, unchanged in *absolute* amount), required 27 per cent of earnings, and was "backed" only by a further 73 per cent. The Preference shareholders were not permitted to board the profits bus until the latter had reached stage 27 instead of stage 23½. The Ordinary shareholders, having similarly embarked at a later stage point, were actually "overcarried" —in other words, their dividend was not fully covered— and Reserves and Carry Forward had a journey in the reverse direction, with their backs to the engine.

It is difficult to conceive of a more convenient method of setting out the position of fixed-interest shareholders over a series of years. Investors can see exactly how their "security" has fluctuated, the rule being, obviously, that the earlier they "get on and off" the stronger their position. Further, they can discover, at a glance, how far earnings would require to fall before their interest or dividend would

be "uncovered." In the example given above, it is evident that profits might decline, in the third year, to one-half or even one-third of their level in the second year, without placing the payment of the 5 per cent Preference dividend in immediate jeopardy. A decline of the former dimensions, however, would necessitate a considerable reduction in Ordinary dividend (if the directors were wise), and a drop of the latter proportions might involve the passing of that dividend altogether.

The "Priority Percentage" method is particularly useful when a company's capital structure is complex, or when capital is being steadily redeemed, year by year. Companies frequently issue Debenture stock, for example, under a deed providing for the re-purchase and cancellation of given amounts of the stock each year. This naturally tends to strengthen the position of the residual Debenture stock, and, indirectly, of all other stocks.

The percentages opposite relate to ten years in the career of Watney, Combe, Reid and Company, Limited, the well-known brewery concern. This company, like many others in its industry, has a complex hierarchy of securities in issue, each having strictly defined priority rights. Its profits had a steadily rising trend throughout the period, with slight setbacks in the fifth and tenth years. In the first five years the company was slowly redeeming its First Debenture stock, but subsequently the amount became constant, and a new series of Second Debentures was issued (ranking for part of a year's interest in Year VIII, and a full year's interest in Year IX). These, in turn, are being gradually redeemed. The company enjoys special power to purchase and cancel, by agreement, its cumulative First Preference stock. Its Preferred Ordinary stock is entitled to a non-cumulative dividend of 4 per cent.

The table deserves close study, as an object-lesson in sound and shrewd finance. This prosperous company has

WATNEY, COMBE, REID & COMPANY LIMITED

Capital, Earnings, and Priority Percentages during Ten-Year Period

			Year I	Year II	Year III	Year IV	Year V	Year VI	Year VII	Year VIII	Year IX	Year X
Paid-up Capital	3½% First Debenture Stock	(£000)	4,458	4,422	4,417	4,389	4,359	4,359	4,359	4,359	4,359	4,359
	5½% Redeemable (Second) Debentures	(£000)	—	—	—	—	—	—	—	2,500	2,375	2,292
	5% Cumulative First Preference Stock	(£000)	1,774	1,738	1,732	1,725	1,685	1,685	1,685	1,685	1,685	1,685
	Preferred Ordinary Stock (4%)	(£000)	3,185	3,185	3,185	3,185	3,185	3,185	3,185	3,185	3,185	3,185
	Deferred Ordinary Stock	(£000)	796	1,593[2]	1,593	2,389[2]	3,185[2]	3,185	3,185	3,185	3,185	3,185
Total Earnings before Debenture Interest		(£000)	*770*	*854*	*857*	*1,360*	*1,296*	*1,341*	*1,365*	*1,557*	*1,632*	*1,489*
Priority Percentages	First Debenture Stock	(%)	0–20¼	0–18	0–18	0–11⅛	0–12	0–11⅛	0–11	0–10	0–9⅛	0–10
	Redeemable (Second) Debentures	(%)	—	—	—	—	—	—	—	10–11⅛	9⅛–17⅛	10–18⅛
	First Preference Stock	(%)	20¼–32	18–28⅛	18–28	11⅛–17⅛	12–18⅛	11⅛–17⅛	11–17	11⅛–17	17⅛–22⅛	18⅛–24⅛
	Preferred Ordinary Stock	(%)	32–48⅛	28⅛–43	28–43	17⅛–27	18⅛–28	17⅛–27	17–26⅛	17–25	22⅛–30⅛	24⅛–33
	Deferred Ordinary Stock	(%)	48⅛–81⅛	43–73	43–80	27–57	28–70	27–67⅛	26⅛–71	25–66	30⅛–71⅛	33–73⅛
	Reserves and "Carry Forward"	(%)	81⅛–100	73–100	80–100	57–100	70–100	67⅛–100	71–100	66–100	71⅛–100	73⅛–100
Deferred Ordinary Dividend Rate			*32%*[1]	*16%*[1]	*20%*[1]	*17%*[1]	*17%*[2]	*17%*	*19%*	*20%*	*21%*	*19%*

[1] Together with Capitalized Bonus, in new Deferred Ordinary Stock, of 100% in Year I, 50% in Year III, and 33⅓% in Year IV.
[2] Deferred Ordinary Stock increased by bonus issue.

obtained the resources necessary for an extensive programme of improvements to its properties by retaining in the business from one-fifth to nearly a half of each year's total profits. The earnings-cover of its prior stocks has, consequently, improved year by year—a process facilitated by the redemption of annual *tranches* of stock. In Year VIII, when the company decided to raise additional money from outside, it took advantage of its high credit status to float an issue in the form of a fixed-interest security (Redeemable Second Debentures) at a rate of interest (5½ per cent) much lower than the percentage return on the capital already employed in its business. Ostensibly, this decision weakened the position of the junior fixed-interest stocks, which had a new security placed in front of their own, without enjoying any share in the "equity" of the new capital (which was automatically passed over to the Deferred Ordinary stockholders). Actually, they were better covered at the end of the ten-year period, after the issue of the Second Debentures, than at the beginning, when no Second Debentures existed, as will be evident from an inspection of the Priority Percentage columns.

A ten-year series of "Priority Percentages", arranged as above, affords probably the best obtainable data for investors contemplating a purchase of Preference shares or Debentures. Broadly speaking, a fixed-interest stock whose "Priority" figures are tending to decrease, over a period of years (apart from temporary fluctuations), is a sound security, other things being equal. On the other hand, a stock whose "Priority" figures are trending upwards (i.e. whose holders board and alight from their "profits bus" at later stages every year) is best avoided. A Debenture whose "Priority" Percentage" rises above 50, in *any* annual period, is a dangerous stock. Investors, indeed, should be on guard whenever the upper percentage figure begins to hover much above 30. A well-secured Preference share should not have

a much higher "Priority Percentage" than 40 as a general rule, and a limit of 60 during abnormal business depression.

Fixed-interest shareholders, no less than Ordinary shareholders, should base their policy on the *trend* of the published figures, and not on the results of any single year. A convenient method is to take three-year moving averages of earnings and of fixed-interest requirements, and to plot the resulting "Three-year average Priority Percentages" on separate charts for each stock, with 0 per cent at the bottom and 100 per cent at the top. Each chart will have an upper and a lower curve. If the two curves have a downward gradient and tend to converge, the stock is "progressive." If the curves are ascending and divergent, the stock is "decadent."

CHAPTER XII

COMPANY ACCOUNTS

UTILITY of balance-sheets—Objections to customary methods of presentation—How to dissect and reconstruct—Liquid, fixed, and fictitious items—Current, fixed, and "equity" liabilities—Examination of reconstructed balance-sheet, from viewpoint of (*a*) Preference, and (*b*) Ordinary shareholders—Limitations of published accounts.

THE attitude of shareholders towards balance-sheets is a curious paradox. These documents have inspired innumerable erudite writers. The shelves of commercial libraries groan with the weight of informative works on "How to Read a Balance-Sheet." Yet few balance-sheets, in normal times, ever *are* carefully read. Fewer still make a definite impression on the minds of their readers.

This state of affairs is assuredly not due to any scarcity of specimens. The humblest company shareholder receives annual letters from the secretary. These do not always, alas! contain dividend warrants, but they seldom fail to enclose a duly certified financial statement. Balance-sheets may, on occasion (like trains on the —— Railway) be more than five minutes late, but they can generally be relied on to arrive, sooner or later.

The number of balance-sheets sent out every year is enormous. *The Economist* regularly analyses the results of nearly 1,800 British public companies in the course of a single year. As its list includes no mines or banks (to name but two missing groups), and takes no account whatever of the host of private companies which send accounts to their shareholders but not to the public, the actual total of such documents, drawn up by accountants throughout the length and breadth of this country in the course of every year, must exceed this figure many times over. Indeed, it has been estimated that the total number of companies

issuing annual balance-sheets runs into five or even six figures.

However difficult a balance-sheet may be to interpret, it is, in fact, the most important document which comes into a shareholder's hands. It is far more significant than a dividend cheque. If the balance-sheet tells an unsatisfactory story, the cheques will eventually cease altogether. In these days, when the divorce between the ownership and control of capital is so complete, the indispensability of the balance-sheet, as the connecting link, is increasingly evident.

It is true, unfortunately, that some balance-sheets are designed rather to conceal essential facts than to reveal them. The soundest companies occasionally publish the most uninformative reports. The reason is twofold. Some directors regard it as impossible to give valuable information to shareholders without revealing to competitors the inner secrets of their business. Secondly, the heads of the accounting profession, who disagree on many things, are agreed at least on one: that as certain figures in every balance-sheet must inevitably be matters of approximation, it is well deliberately to underestimate rather than overestimate *favourable* factors. In the case of weak companies, there may be a third reason, but the less said about it the better.

In no case, however, should the real position be *worse* than the balance-sheet makes out. If it is, there is something radically wrong.

The investor, in his own interest, should be prepared to spend a reasonable time on a close inspection of the report of every company in which he is interested. The results will well repay him for his trouble. He may not obtain anything like a complete appreciation of every factor in the position, but he will save himself many pounds in the long run. A few practical, if unconventional, suggestions may be relevant in this connection. Many shareholders find the

average balance-sheet a baffling document because they make the natural assumption that the figures on either side (which, added together, give a total balancing to a penny) are of a homogeneous character. Most investors have been taught at school that they cannot add together five cows, three sheep, and two horses, and call the result ten pigs. But this is precisely what is done in every balance-sheet.

For example, shareholders may receive a balance-sheet like the following—

BRITISH TEXTILES, LIMITED

(*For convenience, all amounts represent thousands*)

Liabilities	£	*Assets*	£
Preference Shares	6,250	Land, Buildings, Machinery, etc.	8,274
Ordinary Shares	2,211	Goodwill, Patents, etc. (at cost)	1,913
Debentures	3,866	Commutation of Royalties	1,223
Mortgage	150	New Issue Expenses	18
Creditors	635	Advertising and Research Expenditure	146
General Reserve	5	Stock-in-trade	1,765
Depreciation Reserve	1,466	Debtors	857
Mortgage Redemption Reserve	75	Mortgage Redemption Insurance Policy	7
Profit and Loss Balance	230	Investments in Subsidiaries, etc.	136
		Cash	549
Total	£14,888	Total	£14,888

This arrangement is a more or less common form. Only the efforts of many years could have produced a method of setting-out so exquisitely ill-adapted for every practical purpose. Liabilities and assets of entirely different species, arrived at by varying methods of valuation, appear cheek by jowl. Unless the shareholder takes the balance-sheet entirely to pieces and rebuilds it, it tells him nothing, except that the two sides of the balance-sheet, naturally, balance.

Now, (prolonged experience of company reports, good

and bad, suggests that few concerns fail through understatement of their liabilities, compared with the many which come to grief through overstatement of assets. Naturally, shareholders will examine every item on the liabilities side with care, but they will save themselves much time and energy by concentrating their fiercest criticism on the assets side. If the right-hand column of the balance-sheet given above be closely scrutinized, it will be found that its items comprise three distinct types of assets—

(1) *Money, at one, two, or three removes.* These items include hard cash (standing at £549,000 in the specimen balance-sheet given here); or "market" securities which may be turned into cash at something like the balance-sheet figure (none in this case); or debtors, less creditors (£857,000 less £635,000); or finally, stocks of goods, which, given a reasonable time, can be sold, and thus turned into cash (£1,765,000 in the above example). These, as a whole, are generally known as "floating assets," or "liquid assets." Clearly, they enjoy varying degrees of liquidity, from cash, at one end of the scale, to stock-in-trade, the sale of which may require some considerable time, at the other.

(2) *Fixed Capital*—including land, buildings, machinery, and shares in or loans to subsidiaries and associated concerns. In the balance-sheet above, Land, Buildings, Machinery, etc., are valued at £8,274,000, and Investments in Subsidiaries, etc., at £136,000. These are items which the company has no intention whatever of turning into cash. The figures at which they appear in the balance-sheet have no reference at all to saleable values. They are purely "conventional" values put upon the assets by those concerned. They may be based (with adjustments) on what these assets cost the company when it first obtained them—whether this original bargain was a good or bad one. They may have some other basis. In every case, however, what

really matters is their profit-earning capacity, and not what they cost in 1914, or 1066, or any other year.

The small item, Mortgage Redemption Insurance Policy, £7,000, may be regarded as falling into this "fixed" group. It is an asset held in connection with the company's obligation to pay off its mortgage, under certain specified conditions, and is unrealizable for any other purpose.

(3) *Nothing.* Many balance-sheets include certain items which, by an ingenious accounting fiction, represent a valuation put on nothing, or less than nothing. There is a Northern proverb that "you can't get much taste out o' nowt," but some companies have gone far to prove the opposite. "Fictitious Assets" of this character include past losses, expenses which have not been written off, discounts on Debentures, etc. These have no value whatever. They are put in, like Cookery Hints and This Week's Great Thought in the Press, merely to fill up and make the columns balance nicely. They indicate, in fact, *the extent to which the company's remaining assets fall short of its total liabilities.*

The company shown above has the following "Fictitious Assets": Commutation of Royalties, £1,223,000; New Issue Expenses, £18,000; Advertising and Research Expenditure, £146,000. The presence of these items does not necessarily show that the company's finances are in an unsound state. It is, however, *prima facie*, a blot on the balance-sheet, and is recognized as such by all good companies. These endeavour, as soon as possible, to "write off" fictitious assets—in other words, they set aside part of their earned profits, in good British money, to pay off these past losses.

Goodwill—the value of a company's established connection—lives uneasily betwixt and between categories (2) and (3). When a concern is earning good profits, it is a real, if intangible, asset. When there are no profits, it has no value. The safest course is to treat it as a "No. 3 asset"

and write it off—or, better still, leave it at £1, so that financial writers will comment approvingly on it every year. In the particular example under consideration, "Goodwill, Patents, etc." (at cost) is very heavily valued at £1,913,000. As the balance-sheet, in other respects, is not strong, one might be inclined to relegate this item to the "Fictitious Assets" category. The company, however, as it happens, holds a large number of patents, some of which are decidedly valuable. The investor may, accordingly, give the item the benefit of the doubt by placing it among "Fixed Assets" —with a mental note that it includes an unknown amount of "water."

All this may sound "elementary" to some readers. Experience shows, however, that hard-bitten investors are constantly being betrayed into costly mistakes by failing clearly to distinguish between the three types of assets. In actual practice, of course, one cannot add together cash (or its equivalent), future earning power, and losses. Though, for convenience sake, this is done in balance-sheets, it should be the investor's first task to sit down with a pencil and paper and put all the various figures into their proper compartments. The results will frequently astonish him. In any case, this operation is an indispensable initial stage in the investigation of what balance-sheet figures really mean.

Compared with assets, liabilities are relatively simple to classify and understand—though whether any and every liability is fully stated is another matter. They fall, broadly, into three classes—

(1) *Outside liabilities of a current character*, which must be discharged, if and when required, in order that a company may continue in business. An example, in the balance-sheet of British Textiles, Limited, is the item "Creditors," shown at £635,000.

(2) *Outside liabilities of a fixed character*, which, so long

as their service by way of interest or dividend is met, need only be discharged if the company ceases to do business, and is liquidated. They include, in the example given: Mortgage, £150,000; Debentures, £3,866,000, and Preference Shares, £6,250,000. In the event of a liquidation, these would rank in the sharing-out of available resources in the order given.

(3) *Entries corresponding to the equity of the business.* These include Ordinary shares, any undivided profits, and all reserves of a general character (see Chapter XIII). The relevant entries in the specimen balance-sheet are: Ordinary Shares, £2,211,000; Profit and Loss Balance, £230,000; and General Reserve, £5,000.

"Specific Reserves" or "Tied Reserves" (see Chapter XIII) may logically fall into either Group (1) or Group (2), according to their character. In practice, however, the best way of treating them is to deduct their totals from those of the assets to which they refer. Thus, in the present case, the Depreciation Reserve, £1,466,000, should be applied in reduction of "Land, Buildings, Machinery, etc."; and the "Mortgage Redemption Reserve," £75,000, may be deducted from the *total* assets which have a value, or from the fixed assets above, according as the mortgage confers a charge on *all* the company's property, or merely on its land, buildings, etc.

Having thus satisfied himself as to the character of every balance-sheet item, the investor may proceed to re-arrange the whole, so that the financial position stands out at a glance. The method shown on p. 115 is recommended as being both logical and informative.

This is a considerable improvement on the earlier form. It separates liquid assets from fixed assets and fictitious items, and shows at a glance, e.g. how much working capital is available—on paper. It also shows, conclusively, that in a liquidation the Ordinary shareholders would not

BRITISH TEXTILES, LIMITED
(000 *omitted*)

			£
Ordinary Shares			2,211
General Reserve			5
Profit and Loss Balance			230
			£2,446
Liquid Assets—			£
Cash			549
Debtors			857
Stock			1,765
			3,171
Less Current Liabilities—			
Creditors			635
Surplus Liquid Assets			2,536
Add Fixed Assets—			
Land, Buildings, etc.			8,274
Goodwill, Patents, etc. (at Cost)			1,913
Investments in Subsidiaries, etc.[1]			136
Mortgage Redemption Insurance Policy			7
			12,866
Less Specific Reserves—			
Depreciation	1,466		
Mortgage Redemption	75		
			1,541
			11,325
Less Prior Charges—			
Mortgage	150		
Debentures	3,866		
Preference Shares	6,250		
			10,266
Available for Ordinary Shares			1,059
Fictitious Assets—			
Commutation of Royalties			1,223
Advertising and Research Expenditure			146
New Issue Expenses			18
			£2,446

[1] These are held for a *capital* purpose, are non-marketable, and are as much a "fixed asset" as Land, Buildings, etc. Marketable investments, on the other hand, would appear among "Liquid Assets," after "Cash" and before "Debtors."

get back anything like the full nominal value of their shares, and, unless the patents fetched something on a realization, they would get nothing at all.

Having thus rebuilt the balance-sheet on a logical plan, the investor may ask what use it is to him. The answer varies according to the nature of his shareholding. The case of the Preference shareholder may be taken first.

The Preference shareholder is, of all the proprietors of a company, the one to whom the riddle of the balance-sheet is easiest to read. His interest is very sharply defined. He is entitled to fill his bucket once, and once only, at the annual milking. If the cow dies, he has a reasonably forward place in the queue waiting to carve out the carcass.

A balance-sheet, which is a more or less blurred anatomical photograph of the milked or half-milked animal, is of little use as a guide to *income*. On that point the Preference shareholder must consult the past records of the dairy. The balance-sheet, however, affords him important information as to how his capital would stand were the company to come to a sudden end.

Presuming, for simplicity's sake, that there are no Debentures, the Preference shareholder should, in his research, go straight for the "meaty" parts of the balance-sheet—i.e. cash, marketable securities, stock-in-trade, and debtors (less creditors). Here he is, or should be, moving in a world of realities. If the balance-sheet is properly drawn up, the company ought to be able to rake in nearly every penny of these "liquid" assets in the form of hard cash, within a reasonably short time of its ceasing to do business.

If the Preference shareholder finds that the total surplus liquid assets are sufficient to pay him well over 20s. in the £ (always supposing that he enjoys priority for the return of his capital), his task is at an end. He may retire to bed and sleep soundly.

In many cases, however, he will find that "quick" assets

do not fully cover him, and he must invade the debatable land of "fixed" assets. His best plan, then, is as follows—

(1) He should ascertain by how much in the £ the net floating assets fail to cover the Preference capital.

(2) From the remaining assets he should strike out entirely all "never-never" items, like accumulated losses, preliminary expenses, under-writing commissions, etc., and also—to be on the safe side—goodwill.

(3) Taking the tangible items like buildings, plant and shares in associated companies, he should, with pencil and paper, work out how much in the £ these assets should fetch in order to cover the required "deficiency" on the Preference capital. If he is covered by taking these assets at 5s. in the £ on their balance-sheet value, and the company is earning reasonable profits, he may reckon himself reasonably safe. Even if 10s. in the £ is required, he may be covered. Any valuation above this, however, he should, as a conservative investor, regard as increasingly speculative.

All these calculations may, of course, be worth less than the paper on which they are made if the company has been playing ducks and drakes with its finances since the date of the balance-sheet, or if there are claims on its resources which the balance-sheet does not clearly indicate. This is a risk which cannot be avoided, and if the investor happens to be unfortunate in this respect, he may be found subsequently in the ranks of those who advocate the publication of more informative reports at more frequent intervals than twelve months. So far as the available data are concerned, however, such an examination as has been described may be said to exhaust the possibilities of enlightenment from balance-sheet study, from the Preference shareholder's viewpoint.

The exact value of balance-sheets to the Ordinary shareholder is a matter on which even "doctors" disagree. The view of the present writer, given for what it is worth, is

that their practical utility is very much less than it ought to be. For one thing, the majority of balance-sheets are distressingly unilluminating. For another, the Ordinary shareholder's real interest in a company is often misunderstood. He is not, like the Preference shareholder, dealing with something whose dimensions are fixed and measureable. He is the possessor of a share in the "equity" of a business. This is an elusive quantity, which cannot be seen or grasped, and may double itself or become microscopically small, as easily as Alice in Wonderland.

The valuation put on assets in a balance-sheet tells one very little about the value of the equity. The total surplus liquid assets may throw light on how far a company is solvent, and has sufficient working capital to continue its main business. The Ordinary shareholder, however, generally knows that, if ever a crisis forces liquidation, he comes last in the long queue of hungry creditors, and is likely to find the doors closed long before he reaches them.

Fixed assets, in a balance-sheet, usually have reference to original cost (less adjustments), rather than to earning power, or even "break-up" value. The Ordinary shareholder may obtain a certain diversion from the calculation of how much total surplus assets represent, per Ordinary share. He is more concerned, however, with the amount of *earnings per share* over a long period—say, of ten years or more. If a company has gone through at least two periods of severe depression without its earnings falling below, say, $7\frac{1}{2}$ per cent, the Ordinary shareholder may have reasonable confidence. For all he knows, of course, hidden reserves may have been drawn on in these bad periods. These, however, must have been created in good times, so that, taken by and large, the matter averages itself out. In any case, before *buying* a share, the investor will be well advised to apply the tests described in earlier chapters on Ordinary share measurement.

In nine times out of ten, the share of a company which passes such tests is a reasonably sound investment. The tenth case, however, when it occurs, may be disturbing. There are times when the strongest balance-sheet has flaws which the keenest intellect cannot discern. British company history affords many such examples. The Royal Mail Steam Packet Company, after nearly a century's prosperous existence, reached a crisis in its affairs of which some slight warning might, conceivably, have been deduced from a very close scrutiny of its pre-crisis accounts, but which, for the most part, took the whole financial world by surprise. Another company, British Cement Products, came to grief a few months after the publication of a balance-sheet, the bright sunshine of which was marred by no shadow of coming events. The former Armstrong-Whitworth Company paid regular dividends for years, and the news of its difficulties—which necessitated one of the most extensive and intricate reconstructions in the whole history of investment—came as a bolt from the blue.

For all these reasons, the ordinary investor will be well advised constantly to reinforce his balance-sheet impressions with other information, whenever he has the opportunity to do so.

CHAPTER XIII

RESERVES

CONFUSION of thought and terminology regarding company reserves—Distinction between "free" and "tied" reserves—Secret reserves—Renewal funds—Taxation of reserves—True function of "free reserves" to increase permanent working capital—Fallacy of "nest-egg theory"—Reserves as a form of insurance—Investment of "outside" reserves—A suggestion.

No review of the significance of company accounts as an aid, or otherwise, to the investor is complete without an examination of the various methods by which reserves are created, exhibited, used and abused. No subject is of greater importance to the long-term investor, and none is more widely misunderstood. The term "reserve" itself is so loosely used in company practice, that confusion of thought is frequently inevitable. A great financial writer has dwelt upon the perversity of the London Money Market in applying the word "bill" to several different instruments. The term "reserve" is an even more dangerous gin for the unwary.

A scrutiny of British balance-sheets reveals the existence of reserves for multitudinous contingencies. The following is a brief and incomplete list of "reserves" which have come under the writer's notice: General reserve, reserve fund, reserve for equalization of dividends, reserve for income-tax, reserve for bad debts, insurance reserve, depreciation reserve, reserve for stock depreciation, reserve for exploration, advertising reserve, etc. There is also a mysterious species which includes what are known as "secret reserves," or "internal reserves," or, more irreverently, "hush-hush reserves." The existence of these reserves, as of Queen Victoria's legs, it is sometimes considered good form to ignore. That they were regularly maintained, added to and drawn upon, by many of the largest British concerns was common knowledge before ever the Kylsant *cause célèbre* made them

a vexed topic of discussion among members of the accounting profession. Finally, to make confusion worse confounded, other appropriations are made by most companies, which are, in fact, reserves, though they are never called by that name. The most important item in this category is the so-called appropriation for reducing goodwill, which performs exactly the same function as a general reserve. It results, that is, in the addition to working capital of profits which might otherwise be paid out to shareholders. Another item in the same class is the "carry forward" of each year's appropriation account, which is a general reserve slightly more accessible for dividend payments than the majority of reserves, properly so-called.

The investor's difficulties are completed by the variety of practice among accountants and directors as regards the setting out of reserves in company accounts. Some companies show all their reserves separately in their published balance-sheets, and are regularly commended by financial writers for the conservatism of their policy. Others deduct certain reserves from particular assets, and show the assets on a net basis. These companies seldom receive praise, though their real position is identical with that of the former group. Many companies use both methods, for different classes of reserves, in the same set of accounts. Under such conditions, it is easy to understand why confusion of ideas is prevalent. The safety of every company share investment, however, is intimately bound up with the reserve policy followed by the board. Misunderstanding may be expensive. Shareholders, therefore, may be proportionately grateful for the existence of a thread to guide them through the labyrinth of contemporary custom in the matter of reserves.

The clue, in fact, is relatively simple. To take an example of similar looseness in the application of generic terms, there are many kinds of cats and innumerable breeds and half-breeds of dogs. The former, whatever their species,

sex, colour or disposition, can all drink milk, run along walls and fall feet foremost. None, however, can bark, and naturalists who would otherwise have difficulty in distinguishing the two may save themselves perplexity by concentrating on the "barking test," and forgetting all else. There are many kinds of company reserves, but all fall into one of two groups. Any investor who will bear in mind the difference between owing money to himself and owing it to an outside person will readily distinguish between the two.

When a company appropriates certain sums out of its earned profits for general reserve or reserve for equalization of dividends, or even for writing-off goodwill, it is clearly the intention of the directors that the money, if it is ever drawn upon in the future, shall be made over to the shareholders, who are the proprietors of the business. In other words, the company will eventually pay the proceeds, if at all, to itself. On the other hand, when money is set aside as a reserve for taxation, reserve for bad debts, etc., the assumption is that the directors are providing for an eventual *outside* liability, whose exact amount they are unable to assess at the moment. The distinction is of fundamental importance. Reserves for the benefit of shareholders (which for convenience may be termed "general reserves" or "free reserves") represent so much money ploughed back into the business, added to effective working capital, and capable of earning profits, pound for pound, in exactly the same way as money subscribed by shareholders to a so-called "capital issue." Amounts reserved for anticipated liabilities (which may be grouped under the general heading of "specific reserves," or "tied reserves") will ostensibly, in due course, pass out of the company's control and thereafter contribute nothing to future earnings. On receiving a balance-sheet, therefore, one of the investor's first tasks should be to put the reserves shown therein under one or the other of these two categories.

The practical value of this distinction is in no way diminished by the fact that some companies, on occasion, deliberately provide more for outside liabilities than they expect to pay out. The balance is, of course, in the nature of a general reserve. This condition may result from the honouring of the golden rule of accountancy ("Always err on the right side"), or it may be merely a surreptitious method of retaining working capital in the business. It is, indeed, a favourite way of adding to secret reserves.

The legal position of hidden reserves will doubtless be more clearly defined in the course of the next few years. This definition is long overdue. In the present context, without entering debatable territory, it may be pointed out that the extreme facility with which such reserves can be brought into being is itself a strong argument against the likelihood of their falling into future desuetude. Secret reserves are the simplest things in the world to create. Every profit figure the investor sees in a company report is really an estimate, though it appears to be worked out to the nearest penny. An accountant must estimate the amount of debts which will be "bad," the amounts which the Exchequer will require for taxation, the claims of an even more potent Chancellor—Father Time—for depreciation and obsolescence, and many other charges which cannot be *exactly* computed at the time the accounts are made up. The valuation of balance-sheet assets, again, of a "fixed," as distinct from a "floating," character, must needs be a matter of approximation. There is nothing "intrinsic" in the value of buildings, plant and machinery, which depends on future earning power, and affords a fascinating field for exercising the gift of prophecy.

To create hidden reserves, one merely makes allowances, under these and other headings, which are known to be more than adequate. After a few years the resulting secret reserves, in the case of a large company, may run into six

or seven figures, their dimensions being a function of the extent to which design has outstripped mere prudence, or the accomplished fact has happily belied the pessimism of the prophet.

Secret reserves will always have stout defenders, but the investor may, possibly, be somewhat hostile to their indefinite expansion. The keeping of large reserves is a moral duty of every company, and there is no reason whatever why, in the vast majority of cases, these reserves should not be shown. Financial prudence is not more meritorious when directors seek to do good by stealth.

For banks, insurance companies and others whose share capital is only a fractional part of their total working resources, it may be right to frame a policy with an eye to the larger public rather than to shareholders, as such. In other cases, however, secret reserves certainly operate, in practice, to obscure real earning power. By flattening out fluctuations in profits, they may tend to minimize ups and downs in share prices. Over a long period, however, they keep the latter below their true level, since they suggest the assets of a company to be less than they really are. Thus large secret reserves tend, paradoxically, to compel a company to offer new capital at a less favourable figure (from its own point of view) than would otherwise be the case. Finally, if a company encounters a long drawn-out depression, or contracts a fatal "disease," it may conceal the fact for many years by drawing on inner reserves. When these are exhausted, however, the last state of such a company is decidedly worse than the first.

So much for secret reserves, which are, in effect, "free" allocations of whose real extent shareholders are unaware. Another class of "reserves" may be singled out for special comment on opposite grounds—namely, that they are fully and prominently revealed in every balance-sheet, but are much less "free" than investors sometimes assume. Any

reader of this book, who compares the amounts shown under the heading of "Renewal Funds" in the balance-sheets of the main British railway companies to-day with the equivalent figures of the constituent concerns in 1913 (which have been calculated and published since the railway amalgamations of 1922), will discover that the totals show a very considerable increase. This phenomenon has been the subject of much uninstructed comment, and, in some quarters, the companies have been, more or less openly, accused of "hoarding" resources which might more fittingly have been distributed to wage earners and others. The figures, however, cannot be interpreted without reference to the peculiar system of accounting which the railways, together with certain other "public utility" concerns, are compelled by law to adopt.

Under what is known as "the double account system," these companies are required to show particulars of all capital expenditure in a separate account, into which it goes at its original cost figure, and remains there. Instead of writing off depreciation year by year, the companies create various funds, which are drawn on when assets have to be renewed or replaced. Thus, if it is deemed necessary to rebuild and modernize a station, that part of the total cost which represents merely the replacement of the old facilities is charged to the appropriate fund, whereas the cost of "increasing" the station's facilities represents new capital expenditure, and is charged to capital account. Undoubtedly the cost of replacing pre-War assets has increased considerably since 1913. The railways, however, cannot charge to capital any increase *arising merely from higher prices*. They must, therefore, set aside more substantial sums to ensure their continued solvency.

Even railway men, however, will agree that since the War they have done more. For instance, on the doctrine, "an engine for an engine," they have replaced many pre-War

locomotives by much heavier and more powerful engines, without necessarily charging anything to capital account. Some critics have declared that this process is analogous to the creation of "secret reserves," though many railway men maintain that it is merely "ordinary commercial prudence." It is self-evident, however, that the practice results in the provision of certain capital charges out of revenue, and, *pro tanto*, reduces the amounts declared as net earnings and available for dividends. On the other hand, it cannot be reasonably argued that a conservative policy which, were it practised by ordinary commercial concerns, would be commended by all financial critics, becomes vicious when it is followed, under the double account system, by the railways—whose future is by no means as unclouded as it appeared to be before the War. Differences in accounting methods do not change the nature of financial problems. The "free" reserves of the railways, incidentally, are little more than those of pre-War days—largely as a result of the mistaken generosity with which the companies, some years ago, paid out Government compensation money in dividends to shareholders.

Attempts are made from time to time, inside and outside Parliament, to secure more liberal treatment of reserve allocations in the assessment of company profits for income-tax. The latter impost, whose burden has increased unconscionably since the War, is levied in such a manner as to act as a tax on capital in three respects.

Firstly, income-tax allowances for depreciation (i.e. the *maintenance* of fixed capital) are generally inadequate, particularly as regards the elusive but supremely important factor of "obsolescence." Secondly, the tax bears most heavily on the higher ranges of individual income, which are the largest reservoir of national savings. Thirdly, its incidence affects not only profits distributed by companies, but profits put back into the business.

Few investors are aware how large a share of the new capital which finds its way into industry every year owes its origin to company "reserves." The exceptionally well-informed Colwyn Committee put the national savings of Great Britain, in 1927, at £450 millions to £500 millions per annum. Of this total, it was estimated, something like £170 millions to £200 millions (after deduction of income-tax) were attributed to company reserves—in other words, over one-third of the whole.

There is a good deal to be said, on purely economic grounds, for the encouragement of this form of saving. It ensures that a substantial share of the total new capital shall be controlled by those who have shown themselves capable of making the best use of capital already in existence—since companies which have made the largest profits have, naturally, the largest sums to put to reserve. Again, if, as is generally stated, the national income is more widely distributed to-day than in pre-War times, extensive reserve appropriations may act as a corrective to the tendency towards reduced national savings. In effect, they compel the investor to save *before* instead of after he receives his income by way of dividends.

For many years since the War, Treasury exigencies have put the question of tax concession on reserves out of court. If and when, however, the financial situation is sufficiently improved to permit of some remission of the taxpayers' burden, the question may well attain first-rate importance.

That shareholders, as such, do not show greater interest in the question of tax-relief for reserves may be attributed, mainly, to incomplete understanding of the "capital" functions which reserves perform. If a census could be taken, it would be found that a surprising number of investors looked upon reserves as something kept religiously apart from the hurly-burly of business. The idea dies hard among shareholders that, if they were specially favoured,

their Chairman might take them into an inner sanctum, unlock a powerfully guarded safe, and reverently produce —the company's reserves!

This *naïveté* creates misunderstanding in other directions. Investors are frequently puzzled and suspicious on being informed by their directors that the payment of a full dividend, in a year of depression, would involve borrowing from the bank. Why, they ask, should the company borrow when it still has reserves sufficient to cover the dividend? The explanation is simple. No company buries its reserves in the ground. Amounts retained out of profits are capable of producing revenue, and must earn their keep, like the rest of the company's funds.

Suppose the balance-sheet of Prudent Finance, Limited, makes the following showing at the end of Year I—

PRUDENT FINANCE, LIMITED
(*End of Year I*)

	£		£
Share Capital	100,000	Buildings, Plant, and Machinery	60,000
Creditors	30,000	Stocks of Raw, Semi-finished, and Finished Materials	15,000
Profits for Year I	20,000	Debtors	40,000
		Marketable Securities	10,000
		Cash	25,000
Total	£150,000	Total	£150,000

The company, let it be imagined, pays £10,000, by way of a dividend of 10 per cent, and puts £10,000 to general reserve. A less successful year follows, at the end of which the position is—

(*End of Year II*)

	£		£
Share Capital	100,000	Buildings, Plant, and Machinery	55,000
Reserve	10,000	Stock of Materials	35,000
Creditors	40,000	Debtors	50,000
Profits for Year II	5,000	Marketable Securities	10,000
		Cash	5,000
Total	£155,000	Total	£155,000

Profits have fallen to £5,000, and the directors recommend that the dividend be reduced to 5 per cent. Certain shareholders object, on the ground that the board ought to take £5,000 from the previous year's reserve appropriation, and pay the full 10 per cent. The directors point out that they have only £5,000 in cash, and must either sell some of their securities or pledge them for a bank loan, in order to pay such a dividend. What has become of the £10,000 put to reserve twelve months earlier?

Examination of the balance-sheet will show that the company's stocks of materials show an increase, over the year, of £20,000. On the other hand, cash has been depleted by £20,000. Though the company's trade creditors have provided it with an extra £10,000 of temporary "capital," it has been compelled, in turn, to increase the accommodation extended to its own debtors by a similar amount. The reserve allocation made in respect of the Year I has not been retained in cash, but invested in the business, and may be conceived as having been spread over various assets on the right-hand side of the balance-sheet. The reserve appropriation has, in fact, become part of the company's working capital, and can only now be drawn upon by depleting that capital. In other words, to use it for a dividend would result in a contraction, *pro tanto*, of its working capital and the scope of its business transactions, at a time when it is of particular importance that these should be maintained.

Shareholders, in short, should not put their trust in reserves to fill up gaps in dividends. The "nest-egg theory" of reserves is dangerously misleading. Investors should regard reserves as permanent additions to working capital, rather than as a reservoir for future appropriations in aid of dividends. If a company is going steadily downhill, the withdrawal of the amounts represented by its reserves will hasten rather than hinder its arrival in the liquidator's hands. If it is merely suffering from temporary depression (and,

human nature being what it is, every board regards the first evidence of decay as merely a temporary setback), the inevitable reduction in its resources affords the worst possible argument for reducing them further.

This argument suggests a supplementary issue of considerable financial importance. If it be allowed that the primary purpose of reserves is to earn revenue, what is the most effective method of "investing" them? The answer depends entirely on the purpose the directors have in view. If reserves are invested in the company's own business, they may bring in a relatively high "trading" return. If they are invested in high-grade outside securities, they will bring in a relatively low "investment" return. In the former case, however, they will be subject to all the chances and changes of the company's particular branch of industry, and will be lowest when the return on the remainder of the company's capital is lowest, and *vice versa*. In the latter case, their earnings will be much more stable, whether industry in general be active or depressed. They will, in fact, be a species of insurance policy for the first *tranche* of each year's earnings. They will offer the additional advantage that if ever the company needs spot cash in order to

(*Amounts to Nearest Thousand*)

Company	Amount of Stock Held (Mainly Gilt-edged)	Approximate Annual Income, Presuming Average Return of 5%
	£	£
L.M.S. Railway. . .	16,677,000	834,000
G.W. Railway . . .	10,406,000	520,000
Imperial Tobacco . .	10,001,000	500,000
"Shell" Transport . .	9,771,000	489,000
Southern Railway . .	5,146,000	257,000
Arthur Guinness . .	4,657,000	233,000
Vickers	4,629,000	231,000
Anglo-Persian Oil . .	3,280,000	164,000
Morris Motors . . .	2,803,000	140,000
Harrods	1,030,000	51,000

take advantage of an exceptional opportunity, the sale of the securities will furnish immediate resources, without the delay involved in a capital issue. In a period of industrial depression the capital market may be virtually closed to the majority of trading concerns. In any case, it is vastly preferable to obtain capital for urgent extensions by "cashing in" liquid securities than by mortgaging properties for a Debenture issue.

Many of the largest British concerns hold security portfolios of surprising magnitude. On page 130 is a specimen list of such holdings at the time this book was written.

Few industrial companies can hope to rival Imperial Tobacco and "Shell" Transport, whose security portfolios are of considerable magnitude. Every board of directors, however, may ensure that at least part of its company's reserves are held outside the business. In times of prosperity, doubtless, the difference between the return on funds invested in trading and in outside securities, respectively, may appear significant. The only sound method of approaching the question, however, is to average good times with bad. On this basis the amount of the "insurance premium" cannot be considered excessive.

Whether "outside reserves," however, need be invested purely in Gilt-edged stocks, or in a more varied holding of sound securities, giving a higher average income, is another question. In some cases, however, those concerned appear to be less alive to the *income* possibilities than to the "safety first" aspect of their portfolios. If a company holds £1,000,000 in outside securities, an extra 1 per cent on the return therefrom means an addition of £10,000 a year to available profits. If this can be secured without seriously affecting either the liquidity or the stability of the holding, it is by no means to be despised.

This point may be illustrated by reference to the holdings of the ten companies to which reference was made in a

previous table. The effect on each year's income of a potential addition of 1 per cent to the average yield is shown below—

Company	Amount of Stock Held (Mainly Gilt-edged)	Amount of Additional Income [illegible]
	£	£
L.M.S. Railway . .	16,677,000	166,770
G.W. Railway . . .	10,406,000	104,060
Imperial Tobacco . .	10,001,000	100,010
"Shell" Transport . .	9,771,000	97,710
Southern Railway . .	5,146,000	51,460
Arthur Guinness . .	4,657,000	46,570
Vickers	4,629,000	46,290
Anglo-Persian Oil . .	3,280,000	32,800
Morris Motors . . .	2,803,000	28,030
Harrods	1,030,000	10,300

Without presuming to criticize the policy of these companies, one may observe, in a purely general way, that the traditional restriction of "reserve" investments to Gilt-edged stocks is scarcely in accordance with the trend of modern views as to the constitution and merits of a "well-balanced" portfolio.

The severe economic depression of the early 'thirties of this century afforded a striking vindication of the peculiar merits of Gilt-edged stocks in a bear market. In the light of the events of that troubled period, however, few authorities would venture to assert that all trustee stocks are, *ipso facto*, depreciation-proof. A most extensive decline, in fact, was recorded on that occasion in the prices of stocks like Australian Loans and Home Railway prior charge issues. Conversely, the depression failed conclusively to demonstrate that investment in other stocks, yielding a higher income, was incompatible with relative security of principal.

Some of the companies shown in the above table held security portfolios comparable in magnitude with those of

the largest and best-known British investment trusts. The holdings of the Great Western Railway and Imperial Tobacco, for instance, were both valued at a figure only slightly lower than that of the portfolio of the Alliance Trust at the same date. The "Shell's" holding was of the order of that of the Investment Trust Corporation. Arthur Guinness's securities were valued at approximately the same figure as those of the United States Debenture Corporation —and so on.

For various reasons, the policy of companies holding large investments outside their main business can never be on all-fours with that of investment trusts. Nor can industrial concerns hope to obtain an average yield on their investments as high as that earned by the best British trust companies. Nevertheless, it would frequently pay such companies to maintain a senior full-time expert to manage their investment portfolio. When an addition of only 1 per cent to the average yield on their securities means an enhancement of annual income running into four or five figures, it is clear that such an officer, with his staff, might be handsomely remunerated and still earn his keep. In regard to his operations, however, prudence would suggest strict adherence to certain fundamental principles.

First, such an officer should be a paid servant and not a member of the board. He should have no power to buy or sell securities on his own initiative, but only after approval of his detailed suggestions at a full board meeting. Secondly, no securities should be regarded as eligible for purchase which were not quoted, and regularly dealt in, on the London Stock Exchange, and did not satisfy certain stringent rules, laid down in advance, as to stability of past dividends and interest, etc. At least half the total investment should be in Gilt-edged stocks, and at least two-thirds in fixed-interest stocks. The objective is not to secure abnormally high income (which can be attained only by taking a corresponding

risk), but to apply "safety first" principles over a slightly wider field than that of Gilt-edged securities. In particular, investment of more than a very small proportion—say, $2\frac{1}{2}$ per cent—of the whole in the securities of any single financial "group" should be stringently prohibited.

CHAPTER XIV

COMPANY DIRECTORS

STRONG tactical position of directors—Absence of knowledge among shareholders of their identity, duties, and capability—Contemporary methods of company direction—"General utility" and "pluralist" directors—Economics of directors' fees—Should directors have a larger personal stake?—Examples from British practice—A chairman's duties—Directors and market dealings—A directorial institute?—A specialized finance director?

PASSING from the creature to the creator, the investor may turn from company accounts to those who issue and sign them. At the outset, a word of warning is necessary. There are many things which, being unknown, were better not inquired into too closely—what women whisper to each other, what goes into the best soups, and what happens at some directors' meetings.

The governance of companies by boards of directors has been a feature of British company law ever since Parliament made corporate existence and limited liability available for the asking, and completed the separation between the ownership and the administration of industrial capital. Yet there is no body of men of whose actual operations so little is known, and concerning whose functions so much misapprehension exists. Directors' meetings are invariably held behind closed doors. Once the Chairman and the rest of his team have taken their seats at the long table in the board-room, what happens is more shrouded in mystery than a meeting of the British Cabinet. However secret the latter may be, on the most delicate occasions some newspaper always succeeds in "understanding," for its readers, everything that transpires. Only a very narrow circle, however (which seldom or never includes the average investor), learns what transpires at any directors' meeting.

British statesmen, indeed, must frequently envy company

directors their security of tenure, for it is easier to upset a Ministry than a board of directors, so long as a company remains a going concern. In Parliament there is always an organized Opposition ready and willing to provide an alternative Government when a Cabinet quits office. Shareholders, however, are unorganized, and frequently powerless in the face of a "directors' strike." Only those who have tried to work up an agitation against an unsatisfactory board know how formidable is the task, not merely of securing a sufficiently large majority of votes to compel the directors to resign (in the face of the "proxy" advantages conferred on existing boards by the law), but of persuading the right men to stand as opposition leaders and potential new directors.

So long as a company appears to be doing reasonably well, its directors are seldom in the limelight. The names of a few outstanding personalities may be household words in the City, but the great majority of directors are unheard-of men. The investor can readily put this assertion to a test by asking himself to name *all* the directors on the board of any single company in which he is interested. This would possibly be too severe a test for, say, shareholders in British joint-stock banks or main-line railways, whose directorial boards are very large. But how many shareholders of industrial concerns with, say, five to ten directors could name even three members of their boards? How many have ever passed even the time of day with one of their directors? How many could say whether they are short men or tall, clean-shaven or bearded like the pard?

If the investor cannot speak with assurance even on these indifferent matters, how touching is his faith! If he entrusts his resources to those whom he does not know, and has possibly never seen, whose ability and morals he must take for granted, whom should he blame if his gods turn out to be but men? Too often shareholders show interest in their boards only when matters have gone awry. If directors

were subject to the same constant fire of criticism as politicians, their activities might at times be handicapped, but the aggregate results would be beneficial to both directors and shareholders. The existence of a keen "political sense" in a stable community is a healthy sign. As a first step towards the development of a similar attribute in company affairs shareholders should have a clear idea who their directors are, what they do, what they receive, and what value they give for money.

Some years ago, a certain magazine conceived the happy idea of creating a set of characters and asking various authors, independently, to write short stories round them. Character is destiny, but the results of the experiment revealed, nevertheless, some astonishing divergencies. A similar method may be helpful to shareholders desirous of knowing the *raison d'être* of the average board of directors, their methods, and their place in company administration.

Some years ago, an engineering company, whose prospectus was examined by the present author, invited the *largesse* of contemporary investors. It had a board of seven directors, who were respectively described as an efficiency engineer, a consulting engineer, two mechanical engineers, a "gentleman" (presumably in the legal sense of one having no other occupation), a retired colonel, and a publicity agent. This, set down in cold blood, was an unlikely-looking team, but in point of fact it was not unrepresentative of the composition of the boards of many small or even medium-sized public companies. Of its subsequent fortunes the writer has no knowledge, but, for instruction's sake, it may serve as a peg on which to hang various hypotheses of possible board-room developments after its formation.

These seven directors were, in a special legal sense, trustees for their company, which, not being a living person, could not act for itself. They were liable to answer for any

mishap which might befall through betrayal of trust, but not for any honest error of judgment. In other words, while shareholders enjoyed some protection against any predatory tendencies the board might disclose, they had no security against well-meant bungling.

Let it be supposed, then, that the board, having allotted shares to the public and spent the money on capital assets, settled down soberly to their task of administration. They rightly decided to be Marys rather than Marthas—to reserve their energies for broad questions of policy rather than day-to-day administration. They debated long and earnestly the advisability of building a new wing, undertaking a costly advertising campaign, and dividing annual profits, but left to others the dismissal of the office boy for chronic unpunctuality.

They quickly discovered, however, that it was impossible for seven men long to debate round a table without differences in individual ability and mental stature becoming apparent. Before long, the board was tacitly divided into two sections. The first thought and acted; the other "concurred." The consulting and mechanical engineers, whose names were the more impressive, on the prospectus, because they carried their "handles" behind and not in front, were found to know a great deal about cranks and shafts, and very little about the vastly different proposition of running a business. The "gentleman"—a hunting squire—and the colonel knew even less. But the efficiency engineer and the publicity agent had had considerable experience of men and money. In due course they became installed as managing director and chairman respectively, carrying the serious affairs of the business on their shoulders. The board continued to meet once a week, contributing some useful discussion which tended to prevent the outlook of the "specialist" members from becoming too narrow—and, for the rest, formally registered decisions already arrived at.

This system, in practice, gave reasonably satisfactory results, and in due course the company established itself as a regular dividend-payer. The board, however, might well have chosen a different policy. We may suppose, for example, that it decided to set up various sub-committees. The consulting and mechanical engineers devoted themselves to the works side of the business, the publicity expert and the colonel to the sales department, and the efficiency engineer and the squire to the labour and industrial welfare aspect. Each section reported to the full board at its regular meetings.

Rather surprisingly, this plan gave only moderately satisfactory results. All the various departments were found already to be in the hands of paid specialist managers, with full responsibility and a position and reputation to lose, who knew far more about their jobs than any semi-amateur committee could teach them. Ultimately, the company learned the lesson that the real duty of directors was the general supervision and co-ordination of the efforts of the permanent management, and not interference with the latter in matters of detail.

This parable has a universal application. A general utility director, like a Cabinet Minister, is less an administrative officer than a link between heads of departments—the company's permanent Civil Service—and the outside proprietors. Except in the case of a managing director, company direction is not a full-time occupation, and ought not to be. A director's presence is valuable in the board-room in proportion to the width of his experience and the importance of his financial interests outside. This basic conception explains many of the apparent anomalies of which so much is made by well-meaning but ill-informed critics. It suggests, for instance, that under certain conditions a director may be a pluralist without necessarily being a parasite. Certain aspects of British directorial

practice, nevertheless, appear to present at least a *prima facie* case for closer investigation, which may be appropriately based on the published facts and figures of a number of leading British public companies, which are large and, by general admission, well-managed.

The first of these questions concerns the amount and nature of directors' fees. Under Section 128, sub-section I, of the Companies Act, 1929, the accounts laid before a company in general meeting must contain particulars showing the total amount paid to directors as remuneration for their services. Unfortunately, this provision is not completely watertight, since it does not apply to a managing director, nor, if a director holds any salaried employment in the company, is it necessary to state his receipts other than by way of directors' fees. Since the passing of the Act, the number of managing directors employed in Great Britain has shown a noteworthy tendency to increase. Nevertheless, by examining the accounts of established British companies, it is possible to ascertain, broadly, how much the directors, as directors, have cost the shareholders concerned. The figures may err on the low side, but on the whole they will not be a long way out.

The table opposite shows the results of a survey on these lines, based on published figures (at the time of the writing of this book) relating to 15 big British companies, representing many different branches of industry and trade.

Apart from a few exceptional cases, the amount received by the average director is not high, as an absolute figure. Out of the 15 companies, the average is above £2,000 a year only in two cases, while in eight instances it is below £1,000 a year, and in five cases below £500 per annum. For the whole 15 concerns, the average is £1,066.

Whether the figures are high or low, *relatively*, is another matter, which depends on the amount of time and energy each director gives to each company, and the skill and

Company	Number of Directors	Total Directors' Fees 'Last Balance Sheet'[1]	Average Remuneration per Director	Profits Last Complete Year Before Deducting Interest	Directors' Fees as per cent of Profits
		£	£	£	
Great Western Railway	25	25,000	1,000	7,137,634	0·35
Lloyds Bank	34	57,044	1,704	1,929,525	3·00
Guinness	11	5,000	455	2,350,569	0·21
Babcock & Wilcox	7	7,307	1,044	590,709	1·24
J. & P. Coats	15	11,666	777	1,809,852	0·64
Courtaulds	11	24,462	2,224	2,274,400	1·08
General Electric	17	4,575	269	541,446	0·84
Cunard	12	9,030	753	218,501	4·13
Shell Transport	15	20,000	1,333	5,027,118	0·40
Imperial Tobacco	34	10,000	294	10,177,046	0·10
Harrods	8	12,500	1,563	752,482	1·66
Imperial Chemical	16	53,919[2]	3,370	4,473,342	1·21
Marks & Spencer	6	1,500	251	422,002	0·36
Unilever, Limited	29	3,000	104	1,708,850	0·17
Rio Tinto	7	6,000	857	686,000	0·87

[1] Apart from managing directors' remuneration. [2] Chargeable to subsidiary companies.

experience he brings to the board-room. Some directors' services would be cheaply obtained at £5,000 a year. Others would be dear as a gift.

One conclusion can, however, be drawn with some confidence. Whatever the contemporary condition of the market for brains in Great Britain, no business man of first-rate ability and connections can normally be persuaded to give his whole-time services to an enterprise for anything like £1,000 a year, or less. The inference is either that some persons whose abilities are not first-class become company directors, or, alternatively, that really able men take on numerous directorships, on the understanding that they give only part-time attention to each. Both these conclusions have, in fact, concrete force. There is a third possibility, which is so invidious that one ought to be able merely to put it on paper in order to dismiss it—namely, that directors have other means of making money out of their companies than by way of the fees they receive.

If fees are any criterion, however, and directors are successful administrators, the last column of the table suggests that shareholders obtain their services for a relatively small annual outlay. When matters have gone ill,

the first thought of many shareholders is to demand a reduction in directors' fees. Experienced boards know that an awkward situation can frequently be met by throwing part of their directors' fees, or even a whole director or two, to the wolves. Yet in none of the 15 cases analysed above were directors' fees as much as 5 per cent of the relevant year's profits. In nine cases they were less than 1 per cent and in six instances less than half of 1 per cent of profits. If the directors of huge concerns, with branches in many countries, can be persuaded to assume all the cares and liabilities of office for less than 2½d. in the £ of profits, and to do their duty well (as judged by results), shareholders have little of which to complain.

A second question, of fundamental importance to shareholders, concerns the extent of the personal stake of directors in the companies they control. Like all persons whose official position is a target for well- or ill-aimed marksmanship, directors are frequently accused of putting the man before the machine—or, as the Lancastrian would have it, with his accustomed bluntness, of Looking After Number One. Happily for British industry—which for good or ill must remain chiefly in the hands of limited companies—the accusation is without force in all but a small minority of instances. Every conscientious director would rightly resent it, but it has its foundations, nevertheless, in permanent human tendencies and not in mere personal malice.

A man's interest in anything must inevitably be influenced by the stake he holds in it. The owner of a one-man business will scarcely neglect it, since it embraces his entire fortune. A director with a large shareholding in a company will not lightly allow it to drift on the rocks. On the other hand, directors whose constituents are a vague impersonal body of shareholders may, with the best will in the world, tend insensibly to regulate their energies by reference to their

fees alone, if their shareholding interests are negligible. This may be regrettable, but it is human nature.

The desirability of a substantial directorial stake in every business has long been recognized in this country. The Companies Act lays down that every prospectus must show the amount of the directors' share qualification, and the articles of every company go into the matter in some detail. But how do the ideas of those who draft company articles of association square with those of investors generally?

The importance of a director's holding must obviously be related to the size of the concern he directs. A qualification of 100 £1 shares may be substantial if a company's capital is only £1,000, but a qualification of 3,000 £1 shares would be microscopic in a £50,000,000 company. What, exactly, is the practice of the best-known British companies in this respect? Investors can readily put the matter to the test. The following table summarizes the results obtained by an analysis of the data relating to the companies given in the preceding table—

Company	Number of Directors	Director's Qualification	Minimum Amount of Capital Represented by Directors' Qualification Shares	Total Issued Ordinary, Preference and Debenture Capital	*Proportion of Total Capital Represented by Minimum Directors' Holdings*
		£	£	£	%
Great Western Railway	25	2,000	50,000	147,377,111	0·03
Lloyds Bank	34	5,000	170,000	15,810,252	1·08
Guinness	11	2,000	22,000	9,500,000	0·23
Babcock & Wilcox	7	2,000	14,000	4,578,712	0·31
J. & P. Coats	15	1,000	15,000	20,250,000	0·07
Courtaulds	11	2,000	22,000	32,000,000	0·07
General Electric	17	1,000	17,000	10,233,885	0·17
Cunard	12	2,000	24,000	12,070,261	0·20
Shell Transport	15	500	7,500	36,121,361	0·02
Imperial Tobacco	34	10,000	340,000	50,350,561	0·68
Harrods	8	500	4,000	6,215,194	0·06
Imperial Chemical	16	1,000	16,000	70,671,829	0·02
Marks & Spencer	6	500	3,000	3,148,600	0·10
Unilever, Limited	29	500	14,500	14,014,865	0·10
Rio Tinto	7	2,000	14,000	5,750,000	0·24

Investors will learn with surprise that only in one of these 15 cases were the various articles of association drawn

up (at the time this book was written) so as to require directors to hold as much as 1 per cent of the total issued capital. In most instances, the minimum amount was a negligible proportion of the whole. Only in six cases was it as much as one-fifth of 1 per cent of the capital, while in six instances it was less than one-tenth of 1 per cent. For the whole 15 concerns the average was 0·23 per cent. —equal, at par, to no more than three years' directors' fees. In other words, it is quite common to find directors who, jointly, are required to hold less than ½d. of every £ of the capital of their companies. Frequently, of course, individual directors' holdings are many times their nominal qualification. Analyses of shareholders' registers show that directors' holdings, in many cases, are very large indeed, apart altogether from any shares which may be registered through nominees. The point is, however, that unless directors decide differently, at their own unfettered discretion, they have every right to continue to hold their positions as directors, even if their aggregate interests are reduced to a microscopic fraction of the total capital of their companies.

This system, naturally, has its advantages. It allows of promotion from the ranks. It makes available the services of men with brains but little capital. On the other hand, it throws open the profession of company direction to men of straw, who may be mere puppets of large interests, which carefully disguise their own identity.

On the whole, it would seem to be desirable that men of conspicuous ability but little substance should find their place in the higher ranks of the permanent management—where they will receive a proportionately high salary—rather than on the boards of companies. The board-room is the appropriate place for representatives of the proprietors, who should themselves be large shareholders. This is the more important since, as has been shown, the average director's fee is relatively small, and its loss, in most cases,

would not seriously incommode its recipient if a company came to an early and unfortunate end. To ensure the exertion of every possible effort by a director to prevent such a catastrophe, the qualification for office should be sufficiently high to throw the greatest burden of loss on directors, not as directors, but as shareholders.

The moral would appear to be that insistence on more substantial directors' qualifications would tend, in the long run, to produce fewer and better directors.

A third question, on which investors should take pains to be fully informed, centres round the identity, ability and responsibility of individual company chairmen. These occupy a peculiarly important position. Theirs is the duty of presiding over the meetings of the board, of giving, possibly, a casting vote on resolutions of great moment, or—far more significant in actual practice—of skilfully "managing" their team, around the table, so that individual differences of view are seldom pushed to the length of a hostile vote. The chairman, again, is the most intimate human link between the management and the proprietors of a company. His name appears on every report, and his voice resounds from the dais at every company meeting.

The law does not differentiate a chairman from his peers. All the rights, responsibilities, pains and penalties laid down in the Companies Act attach to directors as a species, and not to one who is *primus inter pares*. Nevertheless, his effective responsibilities are those of a company Prime Minister. The extent to which he lives up to them, however, varies considerably from company to company.

Some chairmen are veritable Charlemagnes. Others are Merovingian *rois fainéants*, with a managing director permanently installed as Mayor of the Palace. Others are merely pasteboard and paper, or, like Punch at the fair, strut magnificently on their little stage, and wield a big

stick, while an unseen hand from below decides their action and their fate.

Some chairmen have been associated, without a break, with the building up of powerful businesses from small beginnings. Others are the sons of their fathers, and others, again, are "professionals," who have reduced plural chairmanship to a fine art. Some chairmen interfere little in the businesses over which they preside. Others actively direct the managers and manage the directors.

What is the *beau ideal* of chairmanship? The thoughtful investor would doubtless vote for something between the extremes of interference and inertia. He distrusts the chairman who fetters himself with a mass of detail, no less than the one-sided specialist who has an extensive knowledge of the technique of his industry, but none of finance. He dreads the autocrat and the megalomaniac, who, resenting interference, attempt to administer huge businesses in magnificent isolation, and fail ruinously in their self-imposed task. All these men are dangerous—possibly even more so than the super-guinea-pig whose function it is to justify to his colleagues the decisions of some "group" controller who pulls the strings.

Probably the most useful type of chairman is the man with a catholic knowledge of men and affairs, who may not be familiar with the thousand ramifications of a large company's daily business, but who knows, first, whom he can trust, and, secondly, when another man is talking nonsense. Such a chairman can rarely be expected to give his time exclusively to any one business, and few companies can afford to pay him what he is worth on a full-time basis. In any case, it is indispensable for him, even more than the average director, to have a wider experience than a single concern can afford. He should, on the other hand, be prepared to give much more of his total time to a company than his "general utility" colleagues. It should be made

worth his while—in an open, professional manner—to do so. Investors may usefully endeavour to discover into which of the classes, mentioned above, their own chairmen appear to fall. A few judicious private inquiries will usually yield all the information necessary for a shrewd judgment. If the result is suggestively unsatisfactory, investors will have a *prima facie* constructive case for further inquiry into the status of their shares.

Should a chairman sell? Ought directors to traffic in the shares of their companies? These are delicate questions, but as investors are concerned with facts as they are, not as they ought to be or are sometimes made out to be, nothing will be lost by a frank discussion of their implications.

By all received conventions, company chairmen and directors are men with a sole eye to the welfare of the concerns they administer, who, on assuming office, put behind them all thought of private gain. In practice, a very large number of directors honour this high tradition, in the spirit and the letter, but others are suspected, though they are seldom openly accused, of basing market operations on inside knowledge obtained in a directorial capacity. Nor is it as uncommon as it should be for men with a large number of directorships to have a crowd of hangers-on, who scarcely trouble to disguise their desire to make profitable use of the crumbs of information which fall from their masters' tables. Obviously, profits made by "inspired" operations, in advance of market news, are extracted from the pockets of genuine investors, who buy or sell their shares in ignorance which is not blissful.

It is easy to condemn this sort of thing, but to prevent it is a baffling problem. The law can scarcely prohibit a director from showing his faith in a company by buying its shares, nor can it enact that, once bought, the shares must be retained for ever. Besides, the actual "deals" may not be in the names of the directors at all, but in those of nominees.

To complicate matters, some directors and chairmen, if taxed with the matter, would even maintain, in good faith, that they were guilty of no conduct unbecoming to a gentleman. This is probably the most serious aspect of the whole question, but, at the same time, it suggests, possibly, the most effective way out of the whole difficulty.

The best protection of society against people who drop their aitches, read their neighbours' newspapers over their shoulders, or eat peas with a knife, is not legal proscription, but the inclusion of these acts in the list of things "not done." Social ostracism is, if anything, more potent than statute law in the stratum of society from which directors come. If it became an accepted social convention that a gentleman did not traffic in confidential information at the expense of shareholders for whose interests he was, officially, a trustee, the practice would quickly be reduced to small proportions.

Politics are commonly regarded as not altogether an altruistic pursuit, but in Great Britain, at any rate, a politician who confused public responsibilities and private gain would be regarded as beyond the pale. How many years will pass before the same standard obtains in investment?

The issue is far-reaching. It demands something more practical than either oratorical denouncement or the principle of the blind eye. Matters connected with the size and remuneration of directorial boards, for example, may be involved. It should not be possible for directors to claim—not always unjustly—that their fees are so low as to compel them to eke out their existence, in the state of life to which it has pleased society to call them, by what is virtually a system of private perquisites.

What are the main conclusions suggested by this discussion of the duties, status and policy of British com-

conditions frequently levelled against the whole directorial system by investors whose experience has been unfortunate above the average. The vast majority of British directors are neither supermen nor rogues, but well-meaning individuals doing a job of work as well as their Maker allows them. After every periodical share boom has produced its crop of failures, a hue and cry is raised against *mala fide* directors. The tendency is as abnormal as the orgy of mad speculation which precedes it. If the public has subscribed to overcapitalized new concerns (whether they be patent corkscrew producers or mergers of the largest units in a great industry), it cannot rebut the charge of connivance in their overcapitalization. One must judge directors, in the long run, by the service they give *after* a public issue. Questions as to whether promoting finance could be in better hands, or whether the public's critical powers, as regards new issues, could be sharpened, though of admittedly high import, are not relevant to the present issue.

From the figures given earlier in this chapter, one fact clearly emerges—that directors' fees do not represent anything like so high a proportion of an average company's earnings as is generally believed (apart from the fees of managing directors, regarding which information is difficult to obtain). It is arguable, indeed, that investors would benefit if individual directors' fees were raised and a larger aggregate of time and energy were given to each company. The shareholders' worst enemy is not the wilfully fraudulent director, who deliberately puts himself inside the penal clauses of national company law. An Ivar Kreuger, fortunately, arises only very occasionally. The man who is far more expensive to industry and trade is the respectable, dilettante, unskilful, unattached individual who collects directorships like scalps. Guinea-pigs may cost a hundred times more than their fees if they lack the wit to see that

show insufficient interest in its affairs to prevent their becoming the tools of unprincipled wirepullers.

The suggestion, accordingly, has been made that company direction should be given the status of a separate profession, that a Directorial Institute should be established, and that public opinion should insist on membership of such an institute on the part of every practising director. These proposals have much to commend them. They do not postulate any far-reaching change in the law, which might be difficult to effect. At the same time, they suggest a closer analogy between the "profession" of company direction, and certain other comparable activities. There is no British statute which lays down that auditors must be members of a recognized accounting body, or that stock-brokers must belong to the London or Provincial Stock Exchanges. Informed public opinion, however, more often than not regards a practitioner in either of these professions, who lacks his due qualification, as having a species of bar sinister on his escutcheon. In many other professions recognized bodies exist, with disciplinary powers which they do not hesitate to exercise in proved cases of unprofessional conduct. Their action has in view the protection of the public as well as the maintenance of the good name of the profession. The unfrocked priest and the solicitor struck off the rolls have little opportunity to inflict further damage on the public. Fear of professional ruin is a far more effective deterrent than the prison cell.

There are, however, numerous objections to the plan. Trade is not a profession. The Directorial Institute could scarcely compel its members to sit for a qualifying examination. No body in the world can protect investors against the incapable but honest director. The Directorial Institute, presumably, would give its certificate to all men against whom nothing was known. In other words, it would, like the British Law, give every dog one free bite. No institute

would have refused membership to most of the classic share swindlers at the outset of their career, when they were invariably honest men.

Giants of industry, again, have frequently built up big public businesses from small beginnings. They generally have a keen perception of their own part therein, and would probably tend less to oppose than to ignore the new Institute. The replies of Sir William Morris and Mr. Samuel Courtauld to the suggestion that they should either secure membership or resign from their companies can be better imagined than described. In the long run, however, men of this calibre will always carry the investment market with them. The demand for first-class industrial brains is greater than the supply, and such men will attract capital whether they are Associates of a Directorial Institute, Rechabites, Anti-Vivisectionists, or members of no movement whatever. Possibly, the new Institute would make them all Honorary Vice-Presidents from the outset.

Quis custodiet custodes? The greatest care would be necessary lest the Directorial Institute should become a narrow, exclusive, and tyrannic body. Experience in other directions shows that this is no unreal danger. The Institute would hold powers of professional life and death as regards many of its members. How would these powers be used? After a recent share boom, of unhappy memory, many figure-head directors, seeing disaster advancing across the desert sands, folded their tents like the Arabs, and as silently stole away. By resigning in advance of their companies' general meetings they left their unfortunate shareholders in the lurch, but sought to preserve their reputations. Suppose these directors—some of whom were public men of a certain eminence—being members of the Directorial Institute, had been haled before its tribunal to answer a charge of unprofessional conduct. Would they have pleaded that they were deceived, equally with the public, by the

promises of specious rogues, and that they resigned as soon as they discovered the true facts? Would the Institute have accepted this plea, under which no guinea-pig could ever lose his membership? Or would it have declared that directors must be known by the company they kept, and that the punishment must fit the crime?

Altogether, the suggestion involves very considerable difficulties. Another proposal, made by one of the most eminent accountants of the day, is that every board should be compelled by law to include a Finance Director. It is significant that this idea comes from the accounting profession, which is not altogether happy in its position, under the existing law, as regards responsibility for disclosure, or otherwise, of essential facts in published balance-sheets.

The Companies Act, 1929, has laid down certain minima, but these fall far short of giving the investor all he requires, particularly in the case of holding companies. The financial Press generally pleads for the maximum of publicity, arguing that the shareholders are the proprietors of every company and are entitled to know exactly how they stand. Directors reply that over-disclosure would help their competitors, and that the figures would often be misunderstood.

Apart from questions of law and commercial expediency, the physical difficulties in the way of exhaustive disclosure are considerable. In the case of a certain large British concern, with numerous subsidiaries and branches in almost every country in the world, each year's accounting involves the preparation of the following sets of documents: (*a*) The full reports prepared each year by the accountants, extending to a huge bound volume. (*b*) A detailed summary of these accounts which is furnished to each director. This is a lengthy document of some thirty or forty foolscap pages. (*c*) The balance-sheet and accounts sent out to the shareholders. These comprise a single folded sheet of four printed pages. Even a cursory examination of the three sets of

documents would impress any reasonable critic with the formidable nature of the task of affording shareholders an adequate idea of the "story" behind any single figure in the balance-sheet—except, possibly, the capital and the cash. The duty of a Finance Director, it is suggested, would be to bridge over the difficulty that while a year's revealed figures may be inadequate and misleading, the publication of the whole of the extended accounts is a physical impossibility.

The Finance Director would be a full member of the board, and would share, with his fellow directors, complete responsibility for every decision taken at directors' meetings. It would be, however, his peculiar function to go closely through the complete accounts each year, and to interpret their real meaning to shareholders in a statement accompanying the balance-sheet as a statutory document, signed by himself. He would clear up all doubtful points, explain the context of every figure, and state his considered opinion of the whole financial position.

His powers would necessarily be wide. He would be expected to explain to the directors the financial implications of every major step they proposed to take. Unlike a company's accountant, who is a paid servant, he would be in a position to maintain his point of view in the face of considerable directorial opposition without risking involuntary dismissal. When preparing his annual report he would, unlike an auditor under the present regime, be able to ask awkward questions, and to pry into dark corners. He would, doubtless, perform this task the more readily from the knowledge that if matters went badly wrong he would be the man in the dock. At company meetings he would be present to answer technical financial questions from shareholders—which, by general admission, are to-day most inadequately dealt with by company chairmen who are interested, for the most part, in finance only at second or third hand.

The suggested change in practice, presumably, reflects the widespread feeling that whereas the auditor, in theory, is the shareholders' watch-dog, in practice his function has been whittled down to that of a glorified checking clerk. If he makes himself a nuisance, his connection with the company may be short. Auditors almost invariably are professional accountants, and, like other men, must live. The inevitable result has been a shifting of the balance of financial power from shareholders to directors, on whom, for the most part, there is no check except the Bankruptcy Court.

If the shareholders' watch-dog is to be really effective, it is urged that he must be on the board, and must enjoy the dignity and security of tenure which such a position implies. This suggestion deserves sympathetic examination by shareholders.

CHAPTER XV

THE DUTIES OF A GENERAL UTILITY DIRECTOR

An imaginary letter—Policy regarding management, dividends, reserves, and meetings.

As a "footnote" to the analysis of directorial duties and responsibilities given in the last chapter, investors may be recommended to peruse the following imaginary epistle. It sums up many of the impressions of an acute observer of men, formed during a lifetime's experience as a "general utility" director, and glances at a number of investment problems from an angle which may not be familiar to every reader. It is couched in the form of a letter of advice from a retired chairman, living in the South of France, to his nephew who has just joined the board of his first company.

Cap d'Antibes,
March, 19—.

The pleasures of this Southern spring are enhanced by the news that you have been appointed to your first directorship, under the auspices of the excellent McThurming group. I hesitate to assume the pedagogue's gown, but possibly you will be indulgent towards a veteran who was on the boards of thirty companies (not including subsidiaries) when you were cutting your first tooth.

Most young directors make the mistake of imagining that their role is to direct. Nothing could be further from the truth. You will find that the administration of a large business is an intricate, detailed and whole-time pursuit, which demands a wealth of specialized knowledge, and is best left to the expert. A company run by a weekly meeting of amateur directors to-day will be run by a receiver to-morrow.

You will find, in fact, that real control is exercised by paid managers and a small inner cabinet of directors, who, having spent their life in the business and loving it like a child, will resent your well-meant interference. If they were still running the business with their own capital, you would not be there at all. The public, however, have come in as shareholders, and you have come in with them. You are, in fact, the connecting link

between a specialized management with no interest in the shareholders, and the shareholders with no interest in the management—only in the dividends.

On no account, therefore, should you dissipate your energies over endless business details. Your duties as a "general" director are concerned less with the day-to-day question of earning profits than of deciding what to do with them. But do not imagine, therefore, that your position is a comfortable sinecure. The fate of your company ten years hence may depend on your dividend policy to-day. Do not be surprised to find that those who are cunning as serpents in the running of a business are innocent as doves in such matters as depreciation, bad debts, internal reserves, etc. Nor, as a rule, are they wise in the ways of the world—specialists seldom are.

Therefore, my dear boy, remember that your social position has a definite financial value. Go everywhere, know everybody, attend many dinners, and be present at all public functions—so long as they are reported in the Press. Do not speak overmuch, or ally yourself too closely with any particular cause. You should seldom be heard, but you cannot be *seen* too frequently.

Cultivate the society of bankers, for they will save you when other friends and helpers fail. In the long run, you should be able to assess within £100 the value, in public subscriptions, of your name on any prospectus. If you cannot, be sure that underwriters will.

In the long run, a conservative dividend policy will pay you best. Clothe yourself with financial conservatism as with a garment. But remember that there are garments seen and unseen, and that the better half of your conservatism must be exercised *before* you strike your profit-and-loss.

Do not believe those who declare that shareholders like big profits. Above a certain level, what they really like are steady dividends which are slowly but surely rising. Nothing upsets them so much as to receive 25 per cent one year and 5 per cent or nothing the next. If you wish your shares to be an investment medium and not a gambling counter, choose a moderate dividend and consolidate each upward step before you make it.

Beware if your profits show an immense upward jump. Wise old heads will shake and declare that your advance has been too quick to last. Much worse, the market-rigging fraternity will be attracted. You cannot check their operations, but they will hurt your reputation. Nothing is worse for a company—particularly a young company—than to be involuntarily associated with market scandals.

To avoid these dangers I would whisper in your ear something

which everyone knows but no one publicly mentions. Shareholders, being human, like to see profits distributed, but when the eye does not see, the heart does not grieve. Remember, therefore, to strike your published profits "after providing for all contingencies." The future is a contingency. Be generous, in good times, with your estimation for bad debts. Emphasize the dangers of obsolescence. A pound in an internal reserve is worth two in a balance-sheet. I was young and now am old, but have never heard a board criticized at a general meeting for having *too many* hidden reserves. Let us be frank and recognize that the best companies are those whose internal position is so strong that, in nine years out of ten, their profits depend less on trade than on policy.

This brings me to the interesting question: What are shareholders? Half the world's troubles arise from attaching the same labels to people whose interests are widely different.

You will find by experience that you can separate your shareholders into four distinct groups. There are those who will stick to the company through thick and thin—the permanent investors who will hold their shares till the last trump. Secondly, there are the speculative investors who have taken up semi-permanent residence, but mean eventually to get out at a profit. Thirdly, there are speculators, pure and simple, who are here to-day and gone to-morrow. Finally, there are silent interests who prefer to hide their identity under nominees, and have their eye on some move in a big strategic campaign.

All these groups will bring pressure to bear on you—not by way of eloquence at your annual meetings, but in much more subtle fashion. To try to satisfy them all is the surest way of becoming an inmate of a mental home, for their respective viewpoints are, in truth, irreconcilable. Happily for your peace of mind, your line of duty is clearly marked out. You are to put the interests of the company above those of any shareholder or group of shareholders. Do not be moved by tears because a man has just bought your shares in the hope of a dividend. If the payment would reduce your floating resources below danger point, be cruel.

Never run up your shares in order to make a new issue of capital at an unjustifiably high figure. Never support the market for your shares. Never speculate in your own shares—however cleverly you cover your tracks to-day, the news will be shouted from the housetops to-morrow. If you buy them, hold them as an investment and remember that you can never sell them without a certain loss of prestige. In short, remember that the game is greater than the player, and where there are no rules give the company the benefit.

You cannot, nevertheless, hope to escape a necessity which visits all directors at least once in their lives. Sometime or other you must face an angry shareholders' meeting. If your conscience is clear, you must face it boldly, but not unskilfully. I have seen meetings of all sorts in my time—meetings which opened with prayer and meetings which resembled the Zoological Gardens, but I remember none which was beyond control by a chairman who had studied the technique of Orpheus.

Even at a normal meeting, numerous well-worn maxims will serve you. Exclude humour from your speeches—the atmosphere is all against it. If things have gone well, compliment your staff; if ill, blame the trade cycle. When you are hotly attacked, remember you have the moral advantage of standing on a raised platform. This is one reason why meetings are seldom held in theatres, with the directors on the stage and the shareholders in the dress circle.

Your relative firmness will depend on the number of proxies your secretary holds on the table. Beware of solicitors—find out who they are before replying. If you must give information, give it willingly—to hesitate is fatal. As regards the questions you are asked, a certain amount of previous "co-operation" is sometimes permissible, but this is a delicate subject, further discussion of which is best left to your sound judgment and imagination.

If a meeting is really angry, and your proxies are insufficient, remember that abuse breaks no bones, but shareholders' committees have broken many boards. To avert that, be prepared to make tangible sacrifices. Nothing placates a meeting more than to be told that the size or the remuneration of the board will be reduced.

If your proxies are adequate (and remember, by the way, that you can use the company's money for sending them out), face your shareholders with imperturbable courtesy, wait till the hurricane has blown itself out, and then play your ace.—Yours,

"Cynicus."

CHAPTER XVI

STOCK EXCHANGE REFORM

CRITICISM of the constitution, governance and practice of the London Stock Exchange—Low cost of membership—Too many members—Men of narrow means—High cost of Stock Exchange facilities—Absence of publicity—Split commissions—Dual control—Committee for general purposes—An honorary body—Suggested reforms: new terms of membership, lower charges, limited and educative advertising, a new constitution and a charter, a guarantee fund, a permanent chairman and deputy-chairman, less clear-cut differentiation between broker and jobber—Minor reforms.

EARLIER chapters of this book have dealt (*a*) with the characteristics of different classes of company shares and Debentures; (*b*) with annual accounts, upon which investors must chiefly rely for data regarding the worth of their securities; and (*c*) with directors, whose policy determines the contents, pleasing or otherwise, of company accounts. To complete the present survey of investment principles, reference must be made to the Stock Exchange—the forum in which securities are traded.

Many writers, including the present author, have described the economics and *modus operandi* of the Stock Exchange.[1] Throughout the present work, knowledge on the reader's part is assumed of matters dealt with in every textbook on Stock Exchange practice. The discussion which follows is critical rather than analytical. Does the Stock Exchange perform its indispensable functions for the investor with maximum efficiency at a minimum cost? If not, what reforms in its organization and methods can usually be effected? The Stock Exchange is not a public institution. It is a private concern, registered under a Deed of Settlement. It issues no reports, except to its proprietors. Yet it is an integral part of the machinery of one of the greatest of the world's financial centres. The legend of its immunity from

[1] See *The ABC of Stocks and Shares.*

external criticism might be sustained were its organization perfect or the happenings within its walls of interest only to its 4,000 members, and not to millions of investors in every part of the habitable globe.

Regarded as a financial machine, the Stock Exchange has one outstanding merit. It works. Year in and year out, it provides a point of contact for buyers and sellers of securities, and delivers some sort of goods with more or less regularity. That British industry has been doing precisely the same sort of thing for a long time past, however, has not spared it the necessity of rationalization. Critics who, a few years ago, were accused of "attacking" industry, by insisting that its chances of survival depended upon the ruthless scrapping of obsolete plant and methods, are now reckoned among the benefactors of their age. The thesis of the following pages is that the Stock Exchange is in serious danger of coming under the same condemnation; that its methods are unduly old-fashioned, cumbersome, slow-moving, and costly; and that the future role of London, in a highly competitive world capital market, is bound up with its willingness to adapt itself to the spirit of the times.

An investor who gained surreptitious access to the floor of the Stock Exchange would perceive, before his ejection by the "waiters," that the "House" was a more or less formless structure, with a bulge here and an extension there, each representing some new stage in its annals. This air of brilliant extemporization is omnipresent on the Stock Exchange. There are a few very old members, who pay twenty guineas a year subscription, a much larger number of very new members who pay a hundred guineas, and between them members paying a wide range of different sums. The "Statute Book" of the "House" contains early Victorian rules, Edwardian rules, and neo-Georgian rules. The machinery of the "House," in short, is a piecemeal affair.

A candidate for membership of the Stock Exchange may be a public school product, the son of a member, a "House" clerk of many years' experience, a golfer, an actor, or a fighter. He may be versed in the mysteries of finance or be scarcely able to sign a cheque, for he is required to pass no qualifying examination. He may be as rich as Crœsus, or of relatively moderate means, for, though he is required to pass through the Golden Gate, the Stock Exchange is not unduly exigent in its financial requirements. An outsider can become a member by paying an entrance fee of £630 and a year's subscription of £105, buying a "nomination" and three Stock Exchange shares (the cost of these assets varies with the activity of the "House," but in normal times may be put at an aggregate of about £1,500 to £2,000) and obtaining the "backing" of three existing members for £500 each for four years. If a man has had previous service as a "Clerk" in the "House," his initial outlay and subsequent "running expenses" may be even less considerable. As the nomination and the Stock Exchange shares can be sold when membership is relinquished, an outsider can obtain the full privileges of membership at a dead-weight cost of no more than £735.

The Stock Exchange, in short, applies neither an intellectual nor a really formidable financial test in the matter of new membership. The results are such as might be expected.

In the first place, the "House" is definitely over-populated. It has approximately 4,000 names on its roll—a figure which includes several hundred members who act as clerks only. The number of bargains "marked" each day in the Stock Exchange lists fluctuates approximately between 5,000 and 10,000. Taking the middle figure of 7,500 as "normal," and presuming that one bargain is "marked," on the average, out of every two actually carried out on *behalf of the public* (as distinct from "intermediary" bargains and

other transactions between one member and another), the volume of business averages less than four bargains per member per diem. Even if no more than 25 per cent of the "public" bargains were marked, a normal day's dealings would still produce only 7½ bargains, on the average, for every member.

Contrary to the general impression, it is the exception rather than the rule for single bargains to run into very high figures (except in the Gilt-edged market). What the value of an "average" bargain is cannot be definitely stated, but it is one of the conventions of the "House" that when a jobber has made a double price, he is not expected to buy or sell more than a few hundred shares without special notice, unless he intimates his willingness in the recognized fashion. Business, of course, is not evenly spread. The jobber never deals direct with the public. Some large firms of brokers are very busy, while other members seldom visit the "House." Members do a good deal of business on their own account, and there is a certain mutual "taking in of washing." The Stock Exchange, however, in the long run, must live by serving the public, and the latter's demands could well be met by a smaller personnel.

In the second place, the "House" includes many men who are socially charming and accomplished, with a strong predilection for British games and sports, and a practical generosity that finds outward evidence in a hundred ways. It has many members, in addition, whose intuition in security matters is highly developed, and forms a priceless asset. But the "House" tends to take near views on every question, to rely on hearsay evidence, and, particularly in times of boom, to be moved by the forces of crowd psychology rather than by the sober appeal of facts, figures and, practical possibilities.

Thirdly, though the "House" includes some very wealthy men, a significant number of its members have no more

than moderate means. This factor is important, not altogether as regards the protection of the investor against default, for the professional standard of members is high, and the sound of the "hammer" is seldom heard. A more subtle, but far more common complaint, is that a poor man cannot take his fair share of the burden of carrying temporarily unwanted stock, which must needs be performed if markets are to be given maximum stability and flexibility. He must needs be constantly "evening his book." The "House," in fact, tends to regard activity rather than intrinsic merit as the most desirable attribute of any stock.

The question of Stock Exchange government is closely affected by the conditions attaching to membership. The dual control of affairs, by the Trustees and Managers (who are concerned with internal finance) and the Committee for General Purposes (who fix conditions for dealing, and act as a "Cabinet" of the "House"), will be dealt with later. The Committee for General Purposes, with which the outside investor is chiefly concerned, is a body of thirty, elected each year by ballot of all the members, each of whom must vote for not less than thirty names, or his voting paper is void. As, in practice, any given member knows, as a rule, only about ten or a dozen of the candidates at all intimately, the procedure is not altogether satisfactory. The Committee, when elected, makes a large call on the time of its members, who are unpaid. The result is that many of the men best fitted for service either make considerable financial sacrifices or stay off the Committee altogether. The Committee's efforts, again, are largely hampered by the necessity of moving no faster than a decidedly conservative "House" will allow, and many desirable reforms must hasten slowly "from precedent to precedent," scarcely keeping pace with the evils they are designed to check.

Apart from questions of membership and governance, well-wishers of the London Stock Exchange, who are

anxious to see it rationalize itself along modern lines, have frequently complained of the high level of its charges as compared with those of foreign Stock Exchanges. The British investor is required to remunerate three different parties in respect of the great majority of share transfers made through the Stock Exchange—the Chancellor of the Exchequer, the broker who buys or sells, and the jobber who deals. The extortionate level of Stamp Duties is a great handicap to British investment business. It is defended on the ground only that it is remunerative to the Exchequer —the Treasury, in fact, admitting the charge of "profiteering" but declaring that the Exchequer cannot afford to lose the proceeds of a discriminatory tax on the capital market. Brokerage charges follow a scale graduated according to the nature of the security (shares being more expensive to deal in than stocks), and the price of the shares involved. On shares from 1s. to 2s. the commission represents from 4·17 to 2·1 per cent., and the rates taper off so that on shares between £3 and £4, for instance, commission works out at 1·04 to 0·781 per cent. For very large transactions, certain concessions may be made, by arrangement between broker and customer. It may be that dealings in small denominational shares involve slightly more clerical expense than dealings in higher-priced securities, but the difference is insufficient to justify so wide a disparity in charges at a time when the trend is towards the lower rather than the higher-priced share. In the very low-priced securities the total expense of buying or selling may amount to over 5 per cent, and is a real impediment to frequent dealing. The net result is that London is a more expensive centre to deal in than New York or Paris. Direct comparisons are difficult, but the following table is instructive. The figures are put as closely as possible on a lowest-common-denominator basis, and show comparative transactions as far as may be.

PERCENTAGE COST OF DEALING IN LONDON, NEW YORK, AND PARIS

	London			New York	Paris		
					Parquet		Coulisse
	Industrial Regd. Stock	Shares over 15s. to 30s.	Shares over 1s. to 2s.	$100 to $200	Cash	Account	
	%	%	%	%	%	%	%
Commission, etc.	0·5	1·67 to 0·83	4·17 to 2·1	0·25 to 0·125	0·3	0·125[1]	0·4[2]
Government Tax (Stamp, etc.)	1·0[4]	1·0[4]	1·0[4]	0·04[3]	0·1	0·1	0·1
Total .	1·5	2·67 to 1·83	5·17 to 3·1	0·29 to 0·165	0·4	0·225	0·5

[1] Shares at 200 fr. to 400 fr = 0·25% to 0·125%
[2] Shares at 150 fr. to 350 fr = 0·85% to 0·35%
[3] Sales only
[4] Purchases only.

The burden of taxation, it will be seen, is many times heavier in London than in Paris or New York. But those charges which come within the purview of the Stock Exchange itself, far from being calculated to offset this disability from London's point of view, actually heap Ossa on Pelion, for they are in every case above the rates exacted in those centres which are London's greatest rivals. These figures, however, do not tell the full story. The jobber's "turn" has to be considered. This is generally overlooked by investors, but on a true "costing" analysis it must be taken into account as an expense of dealing.

In answer to criticisms of the high cost of dealing in London it is frequently pointed out that the British investor obtains many facilities which are unavailable in other countries. He is given free advice from his broker. He can, under certain conditions, "undo" a bargain for nothing. He is not usually "sold out" without being first approached by his broker. He may obtain a reduction of commission for a large order. But these special facilities, such as they are, certainly do not justify anything like the discrepancy between charges here and elsewhere. The contention smacks of the familiar English thesis that this country produces for quality only, and the buyer who does not happen to want the best quality can go elsewhere.

The real explanation, however, goes much deeper. Only unsophisticated investors are unaware that an appreciable part of the money may not go into the pockets of Stock Exchange members at all, but into those of a vast body of "half-commission" agents. The services of this cloud of witnesses are, in fact, the chief ancillary facility which the investor is required to finance at so high a cost. It is estimated on some show of authority that about 70 per cent of the whole volume of Stock Exchange business is subject to division of commission. With the scaling-down of this overhead cost, the commission scale could be reduced by

at least one-third without loss to the Stock Exchange. The ramifications of the "half-commission" system are incredibly extensive. Certain Stock Exchanges in the provinces, for example, forbid their members to split commissions. In such a case it is not unknown for an unofficial agent, receiving an order for shares dealt in only on the local Exchange, to forward it, nevertheless, to London, whence it returns to the local Exchange. The client pays at least two charges which are economically unnecessary, but the agent receives his half-commission.

The Stock Exchange authorities have been not unaware of the evils implied in the "half-commission" system. From official announcements made as this book goes to press, there would appear to be every likelihood that the percentage of commission returnable to outside agents, except the banks, will in future be reduced. This will mark a significant break with tradition, but it is doubtful whether it will satisfy some of the more progressive members of the "House." The roots of the problem, indeed, go deeper than a hasty judgment is likely to suggest. The question is bound up with the equally vexed topic of Stock Exchange advertising. Since the "House" persistently denies itself the advantage of modern publicity, it must, in effect, pay others to advertise its facilities *sub rosa*. No member of the Stock Exchange may advertise even to the extent of publishing his name and address in the most reputable daily or weekly newspaper, with an intimation that he is a member of the London Stock Exchange. The Stock Exchange is not alone in its attitude, the Bar and Medicine, for instance, placing an identical ban on advertising. But this practice, which does homage to the Victorian tradition that "trade" is somewhat unworthy of a gentleman of county family, is an obvious anachronism in the twentieth century. Investment services are every whit as "commercial" as banking services, for instance, and the banks are among the most

influential of City advertisers. The "taboo" has more than once lost the Stock Exchange some of its most enterprising members, who have chosen to relinquish their membership in order to expand their business. In a voracious newspaper-reading age it leaves the field of publicity entirely to the "outside" house, which, if *sans peur*, is not always *sans reproche*.

With many of these matters the public has a certain familiarity. The question of divided control, however, is seldom canvassed among outside investors, who tend to regard it as of purely domestic interest to Stock Exchange members. Its consequences are far-reaching. The majority of the Stock Exchange's difficulties can, in fact, be traced to a single cause. (Starting as a private club, it has become a great commercial institution. Unfortunately, its organization has not expanded with its business, and its usefulness is being progressively handicapped by an archaic internal system. The control of its affairs is divided between two entirely separate bodies, whose ideals are altogether different, and whose responsibilities clash in a hundred-and-one ways.)

The London Stock Exchange is a private institution, working under a Deed of Settlement drawn up in 1875 and subsequently amended on several occasions. At the time this book was written, the Stock Exchange had a paid-up share capital of £720,000, together with various Debentures totalling £294,800. Its main asset is the building in which its dealings take place, with other related properties, valued in all at a little over £1,150,000. The financial side of the undertaking is in the absolute control of nine Trustees and Managers, responsible to the proprietors, who have increased since 1876 from 268 to just under 3,000. On the other hand, all matters concerned with the making, marking, and honouring of bargains, the settlement of domestic disputes, and the framing of regulations regarding the wares traded

in on the Stock Exchange, are within the "uncontrolled and uncontrollable" discretion of the Committee for General Purposes. This body of thirty represents the 3,000 odd members of the "House," who are not identical with the proprietors, though for some years past every new member has, in fact, been required to be a shareholder.

Every member of the Committee must be elected or re-elected every year. Every decision taken by the Committee involving, directly or indirectly, a question of internal finance, or affecting in any way the conditions of the deed of settlement, must go to the Trustees, who have an absolute right to veto it without giving reasons. They have exercised this right, in the past, on more than one occasion. Stock Exchange governance, in short, is divided between a body which has no interests outside those of under 3,000 individual shareholders, and a body, which, to its credit, has given implicit recognition to its wider responsibilities towards the State and the investing public. The wider the scope of Stock Exchange business, the more the two interests must tend to clash.

On a narrow view, the Trustees and Managers have deserved well of the proprietors, whose shares are remunerated at the handsome rate of over 30 per cent per annum. But on certain questions their views are rigid. The Stock Exchange has no reserve fund. The present building and its equipment are felt by many members to be inadequate for the efficient conduct, at all times, of a greatly increased business. Finally, the present system ensures that, whenever the short-term interests of the proprietors and the long-term interests of the public are not identical, the former prevail in most cases. An abortive effort was made, shortly after the War, to secure the elimination of dual control, and a more recent agitation secured the support of a large majority of members. The matter, doubtless, will be actively pressed forward, but the way of the reformer

on the Stock Exchange, as in all communities conservative by tradition and temperament, cannot be easy.

Such is the main evidence in support of the charge that the organization, methods, and policy of the Stock Exchange are not in harmony with contemporary conditions in a competitive international capital market. It has been suggested that the personnel of the Stock Exchange is unduly wide and its financial basis unduly narrow; that London's charges compare unfavourably with those of other centres; that a significant part of the money paid in commissions goes, not to provide the investor with better facilities, but to remunerate an army of unofficial agents, whose real *raison d'être* is the unwillingness of the Stock Exchange to utilize the opportunities which modern publicity has placed at its disposal; and, finally, that the system of governance of the Stock Exchange is archaic, producing a dangerous division of responsibility.

To suggest concrete measures of reform is an invidious task. No body is more given to dryly humorous criticism of its own shortcomings, or more apt to resent criticism by an outsider, than is the London Stock Exchange. As the "House," however, depends chiefly for its profitable existence on business transacted on behalf of the general public, its duty and interest both lie in the direction of providing its clients with the best possible service at the lowest possible charge. The criticisms already enumerated suggest, in fact, their own remedies, which may now be briefly considered.

In the first place, it has been pointed out that membership of the Stock Exchange is available to men without necessary qualifications or aptitude for investment business, after a decidedly modest financial outlay, and that the "House" is, consequently, over-populated. It should be frankly recognized that share dealing is at least as specialized a matter as auditing accounts, pleading in the Courts or curing bodily ailments. Before a man can practise as a

qualified accountant, a barrister or a medical practitioner, he must submit to a reasonably prolonged course of preliminary
(1) training and pass a qualifying examination. This, while not a test of genius, is a guarantee of acquaintanceship with the rudiments of the profession. Only on the Stock Exchange can the man of no previous experience, the failed B.A., and the "stickit minister" be assured of admission without question. If the Stock Exchange decided to alter this state of affairs, it would not find it necessary to burden itself with the training and examination of neophytes. It would be a relatively simple matter to set up a body on the lines, say, of the Institute of Chartered Accountants, and whose certificate would be an essential qualification for candidates for membership.

(2) Next, the financial requirements for membership of the Stock Exchange might be raised considerably, and, at the same time, some system of mutual guarantee might be introduced. The existing system, admittedly, has the merit of allowing a man of unusual ability to rise to a high position. Some of the ablest members of the Stock Exchange have, to their great honour, worked their way up from a lowly position. Unfortunately, the system also confers the freedom of the "House" on less desirable parties. In round figures, out of 3,900 members, about two-thirds are brokers who deal with the public and one-third are jobbers who deal only with brokers and fellow-members. Both groups include: (*a*) members of firms with anything from two to ten or more partners, every partner having a separate membership; (*b*) certain members employed by firms, many of whom regard it as desirable to have senior men "in the House"; and (*c*) various free-lances, half-commission men, etc. Some of the members in the last group are relatively wealthy men, who do not wish to assume unlimited liability for the commitments of any partner or partners. Others have valuable specialized experience or connections. Many,

however, are on the margin of Stock Exchange existence and live largely on their wits. It is common knowledge that a minority of members handle a majority of the total business. On the stockbroking side, about fifty or sixty large firms are concerned in more than half the bargains transacted on behalf of the public.

The jobbers include, similarly, partners in firms and individual members with large resources and ample experience of special markets who perform a valuable economic function. At the other end of the scale are men of no substance and no fixed market abode, who endeavour to skim the cream off any business that may be passing, and are an indubitably weak link in the chain. To put the matter quite bluntly, dealing in stocks and shares on a responsible financial basis is not the prerogative of a poor man. It is unfair to both the reputation of the "House" and the interests of the public that there should be any danger of men of straw acting, virtually, as principals in large transactions. The primary difficulty is not so much the possibility of default (against which the whole of the long and honourable traditions of the "House" are rightly directed), but the certainty that there can be no free market for stocks, at all times, and in the full sense of the term, so long as many members are under the necessity of constantly running to "even their books." The Stock Exchange must be in a position to absorb a good deal of stock, if need be, over a significant period of time, and for this large financial resources are essential. How can the rules regarding membership be amended so that these requirements can be met without depriving the man of moderate means of the opportunity to carve an honourable career for himself?

The difficulties are formidable. The Stock Exchange cannot vary the conditions under which existing members have been admitted, without their consent. To do so would be a breach of contract and honour. As regards

new members, however, its hands are perfectly free. It might enact that, on and after a given future date, all new individual members would be required (*a*) to pay an annual subscription of five hundred guineas (instead of the present hundred guineas) and (*b*) to make a permanent deposit of £2,500, which would replace the present method of "sureties." Simultaneously, existing members might be given the option of substituting "membership by firms" for "membership by partners," on a basis, say, of one thousand guineas annual subscription and £5,000 deposit for every three partners, or less, in each firm. Firm-members might be allowed to retain the "floor" services, not only of their present numbers of authorized and unauthorized clerks, but also of a limited number of "House men," whose names they would hand in to the governing body of the Stock Exchange with a statutory declaration that they were "attached" to the firm, which accepted liability for their actions. Men of limited means but outstanding ability would, under such an arrangement, have every expectation of passing, by way of "attached" status, to membership as eventual partners in their firms. The public would enjoy the benefits of ability *plus* stability—both of which are essential to the satisfactory functioning of an institution like the Stock Exchange.

The new terms, while not immediately attractive to many firms, would be increasingly taken up as existing partners resigned or became deceased, and new partners could be admitted to membership only on the revised conditions. The ultimate result would be a Stock Exchange with a total membership well below the present level. Its precise numbers would be difficult to estimate. For argument's sake, they might be put at about 300 firms (or part firms), paying three hundred thousand guineas a year in aggregate subscriptions and making a total initial deposit of £1,500,000, together with, possibly, 500 "individual" members paying two hundred and fifty thousand guineas annually in

subscriptions, and making an aggregate deposit of £1,250,000. The "House" would then have an annual revenue of £577,500 from subscriptions alone (against approximately £200,000 under the present system) and a "mutual guarantee fund" of £2,750,000 (against nothing).

The reply has been made, to suggestions of this nature, that dissatisfied interests might form a rival Stock Exchange of their own. That contingency need cause the "House" little uneasiness. The weight of economic argument and the experience of other centres, like New York and Paris, where membership is stringently limited, alike suggest that such an "outside" market, even if it were formed, would tend to perform a function quite different from that of the official market.

Having increased the stringency of its rules regarding membership, the Stock Exchange would naturally feel itself impelled to tackle the problem of bringing down, by hook or crook, the cost to the public of dealing in London to a figure which would bear at least approximate comparison with that of other centres overseas. The "House" cannot relieve the heavy burden of taxation, except by using every opportunity of impressing on the Chancellor, with the weight of its corporate authority, that killing the egg-laying goose is not, ultimately, a sound revenue policy. It can and should, however, reduce its own charges, first, by better organization (which means cheaper organization), and, secondly, by freeing itself once and for all from the split-commission evil. The corollary would be to allow members to advertise.

The "advertising" controversy is of long standing in the Stock Exchange. The rule prohibiting members from advertising, jointly or severally, is, in fact, more than a century old. A new point, however, has been given to the case for reform by the revelation that a single outside firm, which failed, some years after the War, with heavy liabilities,

obtained a clientele of over 38,000, mainly by ultra-vigorous national advertising. Unfortunately, opinion inside the "House" remains as divided as ever on the wisdom of change, and those who hesitate to approve the reversal of an old rule are unlikely to be convinced merely by fervent exhortation. It may be more profitable, therefore, dispassionately to examine the question of what is meant by advertising, and the probable results of a forward policy.

Though Stock Exchange firms may not even advertise the fact of their membership, they do, in fact, regularly send out to their clients sufficient matter, in the aggregate, to keep any large printing works running day and night. Their missives range from short lists of quotations, and circular letters giving their views on shares and markets, to detailed monthly, quarterly, and yearly records, which may run to extensive bound volumes. Some of the necessary work is mechanical, and may be farmed out. Much of it, however, is highly skilled, and involves laborious research and a fine judgment in expressing opinions upon which clients may risk their money. It brings in no direct return, since a London stockbroker, unlike a Harley Street specialist, does not charge for expressing an opinion but only for performing an operation. In any commercial business house, the considerable expenditure thus involved would be posted to "publicity," as a matter of course. In short, the Stock Exchange, in its individual as distinct from its corporate capacity, spends many thousands a year on "advertising." The latter's scope, however, is restricted to existing clients. Its net effect must be sensibly to increase the volume of Stock Exchange business, but only by way of new orders from investors already inside the charmed circle.

One reason for the ban on advertising has already been alluded to. Fear of a "commercial" taint, though widespread, is instinctive rather than rational. It is difficult to maintain that stockbroking is any less "commercial" than

banking, or the making of engines or the carriage of goods by land and water. All are indispensable parts of a trading and financial system on which the material prosperity of a great Empire depends. The social convention that "trade" is not quite good form for a British gentleman has been an anachronism for so many years that no Stock Exchange member need quail before the logical consequences of throwing it overboard. Once the idea of social stigma has been removed, more than half the battle for advertising will have been won.

There is, however, another objection deeply felt by many members. One may do the cause of Stock Exchange publicity a disservice by dwelling overmuch on the results secured by outside firms who have plastered every breakfast table in the country with their circulars. It is precisely the fear of being compelled to join in an undignified advertising scramble, in which those who shout loudest and most often will obtain the most business, that has given long life to the opposition of many of the older conservative firms in the "House." To-day, while one Stock Exchange firm competes with another, as it must in any "open" market, competition is a free-and-easy "gentleman's" affair, which cheerfully professes to ignore its own existence. Many members subconsciously assume that when advertising comes in at the door, the amenities of Stock Exchange life must leave by the window.

These fears are so much a part of the warp and woof of Stock Exchange psychology that no reformist scheme which fails to take account of them will have any chance of success. A referendum of the members of the "House" on the bare question, "Are you or are you not in favour of advertising?" would almost certainly elicit a negative majority. Such a result, in an institution where precedents are immensely powerful, might set back the clock for five or ten years. Any Committee which itself desired to take the step

would find it necessary first to define, in the clearest possible terms, the limits of possible advertising, and then, by an educative campaign, to familiarize the members of the "House" with the true implications of the policy.

What are the limits of "permissible" advertising? Clearly, it is difficult to see how objection could be taken, on rational grounds, to the insertion of announcements in reputable Press organs, to the effect that So-and-so, as members of the London Stock Exchange, were prepared to transact business for clients under the rules of that body. Such advertisements would help to overcome the difficulty of outside investors who, having no stockbroking connections, are merely perplexed when an application to the secretary of the "House," in the terms of the standard announcement by the Committee, elicits a list of members containing some thousands of names. The instinct of the layman on the receipt of such a document is to plump for the first name on the list, to shut his eyes and use a pin, or, more probably, to give up the whole business in disgust.

If Stock Exchange firms were permitted publicly to advertise their identity and credentials, there would be no sound reason why the fruits of their painstaking care in preparing informative circulars should not be made available to a wider public. For many reasons, touting for business through the post might well be strictly forbidden. There would, however, be nothing undesirable in allowing outside persons who wrote up for information, in response to a firm's Press advertisement, to receive copies of its circulars. Similarly, no objection could arise to Press discussion of matters of general interest touched on in brokers' circulars. The source of the information might then be acknowledged, as in the case of the monthly Reviews of the great joint-stock banks—provided, of course, that no payment were made by the firms concerned, under pain of expulsion from the "House." Such comment, in fact, frequently appears

in the Press to-day, though editors are compelled to introduce it by vague formulae ("a well-known firm of stockbrokers declares . . ." etc.) which do not always conceal the identity of the parties.

Even if prudence suggested the limitation of individual advertising to these relatively modest forms, a wide field would remain for corporate advertising under the aegis of the Committee. Hatry is a name of evil repute on the Stock Exchange, but that financier undeniably brought much new business to the "House" by his publicity campaigns on behalf of corporation securities, however disastrous his own operations may have been. His advertisements were invariably "educative." They did not attempt to push any specific security, but stressed the merits of corporation issues in general.

Well-conceived "instructional" publicity, indeed, on such lines, serves a moral as well as a business purpose. An excellent example is a standard Press advertisement of one of the large banks, giving a list of leaflets, obtainable on application, on such subjects as "Points Before Travelling," "Advantages of a Banking Account," "The Saving Habit," "Foreign Exchange," "Wills, Trusts and Settlements," etc. Such "advertising," undertaken by the Stock Exchange Committee in respect of investment matters, would be a boon to thousands of potential investors who find security dealings a mystery in the modern as well as the medieval sense. Only a jaundiced eye could see in it any derogation of the dignity of a great institution.

While "bludgeoning" advertisements and other extreme forms of modern publicity might rightly remain taboo, advertising on the lines suggested would overcome the fundamental defect of present organization—the absence of any method of direct contact between the Stock Exchange and the outer public. Members of the "House" know perfectly well that business does not come by standing and

waiting, but by going out into the highways and by-ways to look for it. The method of employing a nondescript army of commission agents for this reconnaissance is both unsatisfactory and costly. It lends itself to all sorts of irregularities. It may involve Stock Exchange firms in ill-defined and embarrassing legal liabilities. A policy of judicious constructive advertising might provide an alternative method of bringing potential investors and the Stock Exchange into direct touch, and eliminate part of this expensive leakage of funds. In the long run, it would pave the way for a reduction in minimum commission rates.

Sooner or later, the Stock Exchange will be compelled to carry out a reform which has long been urged from within —the abolition of dual control. This particular problem, however, has very extensive ramifications. The question at once arises—if unified control were deemed indispensable to the progress of the Stock Exchange, could it be effected by merely amending the 1875 Deed of Settlement? If a new deed were proposed, the members would be compelled to face the issue whether a "club" organization was the most suitable for an institution of international scope and responsibilities. Should the Stock Exchange, like the Bank of England, obtain a Royal Charter? Should it have power to demand of its members a substantial initial deposit, for the creation of a mutual guarantee fund?

Other points of principle would be involved. Should Stock Exchange dealings continue under the control of a Committee whose members receive no remuneration other than free lunches, who, with all the will in the world, may have to make an invidious choice between neglecting the claims of their own business or those of the Stock Exchange; and who are liable to be overthrown at any annual election if they follow a policy which does not appeal to the immediate predilections of the majority of members? Should the governance of the "House," contrariwise, be in the hands of

a more permanent Governor, with a specialized, full-time, and well-remunerated administrative staff under his direction (including a practical economist of acknowledged repute), assisted by an advisory body of members, corresponding in personnel with the present Committee, and possessing approximately the same powers as the directors of the Bank of England?

There can be little doubt that the second of these alternatives is preferable. At present, one must regretfully admit, a constitution which has outlived its usefulness is the greatest obstacle to many concrete reforms whose indispensability is admitted on all sides.

There is frequent criticism outside (seldom inside) the "House" of the rigid differentiation, in London, between broker and jobber. The latter, as such, is an old-established institution in London (though not elsewhere), and a formidable body of opinion believes that he does, in fact, give flexibility to markets and stability to prices. This consideration, however, does not sanctify London's policy of compulsory segregation of members into one of two watertight compartments. If the jobber's claim is well-founded (as the present author believes it to be), economic forces will maintain him as an institution far better than any "trade union" distinction. But the jobber who will not sell any but the most active stock until he can see it on his book, and, once it is there, immediately wishes to get it off again, can well be replaced by a blackboard, which, incidentally, takes no "turn." In practice, it would be found, under a regime of free choice among members, that while many buying and selling orders could be settled between the buying and selling brokers, without a third party's intervention, "specialists" would emerge for particular lines of stock. These specialists, however, like their counterparts in New York to-day, might find it advantageous to deal both with other brokers and their own outside clients, as occasion required.

The economies of rationalization, finally, extend to small matters as well as large. There is, for instance, a greater discrepancy than there should be between the net economic cost to the investor of dealing in stock and dealing in shares. Registered securities, again, are much more common in London than Bearer securities, and although the former have certain advantages in the way of safety, they frequently involve delay in transfer, and certainly do not make for active *international* business. The question is not one for the Stock Exchange alone—the omnipresent Chancellor of the Exchequer comes into this particular equation, together with the views of company directors—but if the weight of the considered opinion of the "House" were thrown on the side of methods which gave the maximum facility (and the maximum cheapness) to dealings, its effect on the other parties concerned would not be inconsiderable.

This catalogue of recommendations might be greatly extended, but enough has been said to indicate the main lines which, in the writer's opinion, any far-seeing scheme of Stock Exchange reform must follow. It has been designed with no fault-finding purpose. The difficulties are formidable, and there is nothing to be gained by ignoring their existence. In the long run, every indispensable part of the machinery of an international centre must conform to international standards. But while the occasion for new ideas and methods may come from without, the initiative for their adoption must come from within. The author trusts, therefore, that the Stock Exchange will accept the above suggestions in the friendly spirit in which they are offered.

There are two reassuring principles which the "House" can be relied upon to bear in mind. The first is that no institution has ever penalized itself by increasing its efficiency; the second, that, in the long run, what is best for one's clients must be best for one's own business.

CHAPTER XVII

INVESTMENT TRUSTS

FUNCTIONS of the investment trust—A specialized investment agency—"Amateur" *versus* "professional" placing—"Management" and "fixed" trusts—Exaggerated claims—Dangers of giving a blank cheque to directors—Need for wider publicity regarding holdings—Stability and high income do not automatically follow the "spreading" of risks—Methods of established British companies—Distribution of holdings between (*a*) bonds, preference shares, and equities, and (*b*) domestic and foreign securities—Importance of reserve accumulation—Objections to "fixed" trusts—Heavy initial charges—Forced sales—"Jobbing backwards"—Whole idea of "fixity" repugnant to sound investment principles.

THIS book is not concerned with the status of specialized share markets or individual securities. Its purpose is not to discuss the merits of railway stocks, brewery equities, or mining counters, still less those of London and North-Eastern Second Preference, Bass Ordinary or Ashanti Gold, but to formulate certain general principles, in the light of which any given proposition may be judged. It deals, in short, with investment, not investments. One type of share, however, demands detailed examination even in a work of this scope, since its *raison d'etre* is not the exploitation of any particular branch of industry, but the application of definite investment theories.

There is a certain advanced school of thought in Great Britain which contends that the small private individual will be slowly but relentlessly compelled to relinquish his initiative in the business of practical investment. The forces at work, it is declared, are much the same as those which have driven the small man out of most industries, except the inefficient. Sooner or later, the individual will discover that it does not pay to pit his own ill-informed judgment and limited resources against Fortune and the big battalions, and will decide, instead, to hand over the whole business, lock, stock and barrel, to expert co-operative

investment organizations. A time must come, in short, according to this view, when the *provision* of capital will remain the prerogative of the private investor, but the *direction* of the national capital into economically profitable channels will be the duty of specialized and powerful investment bodies.

The building society, the insurance company and the investment trust all claim to secure a high degree of safety of capital for the investor by the "spreading" of risks. In the case of the building society, this risk-spreading is confined to one class of "real" property, and, in the case of the insurance company, more or less to loans, mortgages and fixed-interest securities. The investment trust, however, goes farther afield, and spreads its investment risks among both fixed-interest and variable dividend securities in varying proportions. The investor who takes out a life or endowment policy hands over, in fact, the business of spreading his risks to an insurance company. To obtain a wider "spread," he may purchase the Debentures, Preference stocks or Ordinary stocks of an investment trust, which has been formed to hold a widely-diversified portfolio of securities, to collect annual interest and dividends thereon, and to pay the proceeds (less deductions for reserves and relatively small management charges) by way of dividends to its shareholders. The composition and modification of the security portfolio of a "management trust" are left, within wide limits, to the discretion of the directors and managers. The management, in the case of a "fixed trust," are authorized to purchase only a relatively short list of securities, in specified proportions. These securities are held in trust on behalf of their beneficial owners for a given number of years, subject to conditions under which the management must (or, in some instances, may) sell out a given stock after the occurrence of a defined contingency, e.g. the passing of a dividend. The "management" type of trust has been

known in Great Britain—its native land—for half a century. The "fixed" type is an American innovation of the third decade of the present century. Over 200 British "management" trusts proper are in existence, with a total issued capital (including Debentures) of more than £300,000,000. The "fixed trust" had a considerable vogue in America during the Wall Street depression of 1930-31, when the "management trust" (recently introduced from Great Britain, and developed with more zeal than discretion) was temporarily under a cloud. In Europe, however, the "fixed trust" has been taken up by investors only to a relatively small extent.

Whether the investment trust, as its more extreme friends suggest, will ultimately obtain something like a monopoly of the business of collecting capital from private investors and redistributing it over the industrial field, the future must be left to show. Certainly, that time is not yet. During 1928, the most active year in the British capital market of recent times, when the abnormally rapid formation of new investment trusts was the subject of widespread comment, the capital raised in London on behalf of *all* investment trusts was only approximately £30 millions out of a total of £369 millions. That the trust both deserves and enjoys the goodwill of many conservative investors, however, is undoubted. Both in the Baring crisis of the 'nineties of the last century and the world depression of the early 'thirties of the present epoch many "young" investment trusts saw the market value of their securities fall so largely below "book" levels as to leave their issued Ordinary stocks uncovered by any assets on a break-up valuation. But the majority of holders of these stocks refused to part with them, and their market value remained well above zero during the worst phases of both crises.

Experience suggests that the faith of investors in the recuperative powers of the majority of British investment

trusts, under skilful and conscientious management, has not been misplaced. The events which called for the exercise of that faith, however, are themselves a strong argument against unquestioning acceptance of the thesis that all investment risks are automatically eliminated by the purchase of a trust company stock. No investment trust has discovered the philosopher's stone, and if such a belief ever became prevalent, its inevitable consequence would be widespread public victimization and costly disillusionment. Why should it be less dangerous to hand over one's resources to a board of directors to employ (more or less) as they will than to entrust these directors with capital to be used in a definite way, with specified safeguards (on paper, at least), after they have made out a *prima facie* case for its employment in a given industry? It may not be inappropriate to endeavour, in the following pages, to clear up a number of points, as regards investment trust finance, on which somewhat hazy ideas are commonly prevalent.

In the first place, there is no document in the world which gives less information than the average investment trust prospectus. Usually, after a few platitudes regarding the advantages of large-scale investment and risk-spreading, the investor is informed who the directors are, what are the restrictions on borrowing, and the maximum percentage of total capital (say 15 per cent), which can be invested in any one security. *C'est tout.*

Could confidence be stretched much farther? The directors do not say (except in the broadest possible form of words) what securities they propose to buy. The trust, indeed, may conduct a most successful business for years without its stockholders having the slightest idea as to the composition of its portfolio. Out of 205 investment trusts analysed in a well-known manual, less than 70 publish lists of their investments. Much ridicule has been poured upon a classic company, formed during the South Sea

Bubble, to "carry on an undertaking of great importance, but nobody to know what it is." This, in fact, is precisely the proposition put forward by every new investment trust which does not intend to publish details of its portfolio. For all the investor is aware, the company may expend his money on the purchase of seven securities, or seventy or seven hundred. It may spread its purchases over many industries, or countries, or it may believe that a short cut to prosperity lies by way of investment in Mr. B. Wyldecat's group of companies. The subscriber to a new investment trust company is absolutely in the hands of his directors, to whom he gives the nearest equivalent, under British Company Law, of a blank cheque.

That these loose arrangements have worked well in the past is due entirely to the high standard of skill and probity which has obtained among the investment trust promoting and directing houses, with very few exceptions. If, however, a boom were ever to occur in new investment trust securities, the possibilities of abuse would be alarming. In such a contingency no earthly power could exclude from the market the two classes of promoter from whom the investor has most to fear: the unscrupulous gentleman who is out for all he can get, and the crank who has a perfectly honest enthusiasm for an entirely unsound idea.

In practice, the subscriber to an investment trust issue has one reliable indication of its quality, and one only—the names on its prospectus. There are certain well-known "studs," in Edinburgh, London and elsewhere, which have produced winners in the past. Shares in successful established trusts are frequently difficult to obtain, but discerning investors wait for the new horses from these stables, and back them on their trainer's reputation. The investor can generally obtain information from his broker as to the interests behind a new investment trust.

In the present writer's opinion, investment trust sponsors

and managers have a duty to the public to furnish much more comprehensive information regarding their companies. It may be suggested that existing trusts should invariably publish lists of their investments each year. New trusts should give much clearer indications, on their prospectuses, of the way they propose to allocate their funds between Bonds, Preference, and Ordinary shares, between different countries and between different industries. The directors should undertake to publish, within a prescribed period before the issue of the first report, a full catalogue of the stocks they have purchased.

The private investor, further, is entitled to detailed information as to the connections and record of the names on every prospectus. The latter's contents ought to include a list of all the companies (whether "investment" or "operating" concerns) with which the directors are connected. The really important names, frequently, are those of the managers of the trust. The investor has a right to know what other trusts are managed by these interests, and what their results have been as regards earnings and dividends during, say, each of the previous five years. Such information is common knowledge among "insiders" and large investors, and there would be nothing derogatory to the dignity of the heads of the large investment houses in making known the facts to all concerned. They, of all men, have least reason to hide their light under a bushel. (If it is desirable that the investor should place the business of investing his resources in expert hands, he is at least entitled to scrutinize the expert's credentials.)

When the capital of a new investment trust has been subscribed (the directors, in many cases, having "placed" a substantial part of the issue among their friends and connections), its potential earning power is the subject of much confusion of thought among investors. A modest experience will convince most people of the difficulties of securing an

average income yield of much over six per cent on a diversified private holding, without running appreciable risk. Yet many investors assume, as a matter of course, that the "spreading" of a large investment trust's holding, according to some mystic formula, is sufficient of itself to combine safety and satisfaction with seven per cent.

The problem, in fact, is much less simple, as investors learned to their cost after recently subscribing to various trusts formed under "co-operative" auspices, which promised to pay 7 per cent. Ordinary dividends from the crack of the pistol. It was not long before the directors were faced with the alternative of lower dividends or perdition, and chose the former. There is, indeed, no magic about investment trust earnings. Boards of directors and management houses of good repute obtain long-term capital through the normal public and private channels of the new issue market, "adventure" it in the purchase of a mixed bag of securities, and subsequently, in many cases, obtain further working resources by pledging their investments as collateral for bank loans. Thus a trust may obtain the major part of its effective capital at fixed interest, by way of bank advances, Debentures and Preference stocks, only the residuum being equity stock. The Ordinary stockholders' hopes of steadily increasing dividends depend entirely on the managers' ability to re-invest their funds, so as to obtain a higher yield than the trust pays on its fixed charges.

Investors should consider exactly what this means. Gilt-edged securities, broadly, are of no use to an investment trust. They yield, on the average, less than the rate it pays out on its own fixed stocks. The big clients of the Gilt-edged market are rather the insurance companies—whose life policy-holders are content with a "yield" below that of Gilt-edged stocks—and the banks. The banks obtain a large share of their effective working capital at the cost

merely of running their customers' current accounts, and another big slice at a relatively low "deposit rate." In addition, they have other and more profitable ways of employing their resources than investment in Gilt-edged stocks.

An investment trust company must go far afield to discover its income. In practice, to bring up its average yield figure, it must hold *some* equity stocks and a good many foreign stocks. An illuminating test of investment trust practice can be made by tabulating the "distribution" figures of those British trusts which regularly publish lists of their holdings. The following table, showing the allocation of total investments (*a*) as between Bonds, Preference and Ordinary securities; and (*b*) as between British and overseas

DISTRIBUTION OF HOLDINGS OF TYPICAL BRITISH INVESTMENT TRUSTS

Name of Trust	When Registered	Distribution of Holdings			Geographical Distribution	
		Bonds and Debentures	Preferred and Preference	Deferred and Ordinary	Great Britain	Empire and Foreign
Pre-War Trusts—		%	%	%	%	%
Caledonian	1910	49	29	22	30	70
East of Scotland	1913	26	21	53	46	54
First Scottish-American	1879	52	28	20	[1]	[1]
International Financial	1865	[1]	[1]	[1]	38	62
Railway Deb. and General	1873	71	14	15	[1]	[1]
Scottish Western	1907	48	29	23	32	68
Standard	1903	33	25	42	37	63
Post-War Trusts—						
Ailsa	1927	40	24	36	[1]	[1]
Anglo-Celtic	1925	44	19	37	[1]	[1]
British and German	1926	51	16	33	14	86
Capital and National	1927	53	29	18	25	75
City and International	1926	47	14	39	35[2]	65[2]
Continental and Industrial	1924	[1]	[1]	[1]	19	81
General Funds	1927	33	28	39	[1]	[1]
Hellenic	1928	70	11	19	[1]	[1]
London and Holyrood	1929	45	35	20	15	85
London, Border	1928	30	19	42	25	75
London Stockholders	1928	27	33	40	27	73
Mid-European	1924	56	11	33	23[2]	77[2]
1929 Investment	1929	39	27	34	23	77
Romney	1924	36·3	19·4	44·3	46[2]	54[2]
Second London-Scottish	1927	50	24	26	52	48
Second Scottish United	1928	[1]	[1]	[1]	50[2]	50[2]

[1] Not disclosed.
[2] Includes holdings in British Empire.
[3] Excluding British Empire holdings.

securities, was obtained by placing the list of such companies, available at the time of writing, in alphabetical order, and extracting the figures for the first, fifth, ninth, fourteenth . . . and every fourth succeeding company. The companies were then re-grouped into "pre-War trusts" and "post-War trusts."

The table shows that, out of twenty trusts which showed distribution by nature of stock, only three had less than one-fifth of their holdings in equity securities, while twelve had a third or more invested in equity securities. Out of seventeen which gave the geographical distribution of their portfolios, sixteen had 50 per cent or more of their holdings outside Great Britain, while nine had 70 per cent or more placed overseas. Any investor, indeed, who perused the lists of holdings of many investment trusts would find some strange-looking specimens, which certainly were never registered in the "stud" book, including foreign bonds of which he had never heard, and other securities unquoted in London.

Actually, these may be perfectly sound and remunerative investments. The art of finding them is one of the indispensable accomplishments of a good trust company manager. The popular belief, however, that investment trusts can rapidly get into and out of their holdings, in response to changing market conditions, will not bear examination in the light of these facts. It is not altogether easy to dispose of numerous investments, even under active market conditions. In a bad slump, however, the scope for "getting out" may be painfully limited; hence the axiom, well-known and honoured in investment trust circles, that it is better to keep out of bad stocks than to endeavour to get into superlatively good ones. Investment trust practice on British lines, in short, requires caution and enterprise, with the former in the ascendant. This is a peculiarly Scottish blend of qualities, the necessity for which explains

the distinguished part Scotland has played in investment trust development.

The upshot of this argument is that while the practice of "spreading risks," followed by British investment trusts, yields valuable results, these are achieved along lines which make for a certain rigidity, particularly in times of world-wide depression. It is a frequent bone of contention, indeed, whether the strength of the old-established British trusts is due primarily to the diversification of their holdings, or to the cumulative effect of austere conservatism in their internal finance. The tenets of orthodox investment trust policy are such that no prudently managed company, in normal times, can operate for long without accumulating handsome reserves.

These reserves accrue chiefly from two sources. In the first place, dividends are kept well below earnings. This practice, indeed, has been reduced to a fine art and has much to do with the undoubted attraction of trust company stocks for taxpayers. While some companies pay out increased earnings by way of enhanced dividends, others make no secret of their intention to stabilize their dividends at a certain level, and to make further distributions by way of periodical issues of bonus stock. These, being of a "capital" character, escape the incidence of tax. In the second place, good British investment trusts buy and hold securities for revenue purposes only. They may obtain them, at the outset, below the market level on "underwriting terms," and they may, and do, in good times, dispose of some of their holdings at a profit. Such profits, however, are regarded as incidental to their main business—so much so that in most cases the articles of association definitely lay down that they are not available for cash dividends. The Inland Revenue itself treats them as capital items, which are not subject to deduction of income-tax.

Persistent reserve accumulation, over a considerable

period, tends progressively to increase effective working capital, while nominal capital remains unchanged. To this cause, rather than to any magical outcome of "diversification of risk," is attributable the steady increase in earnings on Ordinary stocks, in normal times.

In the light of this analysis, the common view is clearly untenable that investment trust practice is so simple a matter, thanks to the mystical properties of "risk-spreading," that the wayfaring man, though fool, may not err therein. The opposite is the truth. Successful trust company administration is an intricate business calling for peculiar *personal* qualities of conservatism and enterprise, which are rarely combined in a single individual. A trust company manager must, in addition, have friends of the right sort, a keen nose for opportunities, a balanced judgment, and not a few of the accomplishments of the Major-General in "The Pirates of Penzance." Investment trust finance, it may be concluded, is not a principle of investment, but an example of the application of investment principles. There is nothing "automatic" about its success or its failure. In either case the human factor is dominant.

This is the fundamental objection to the so-called "Fixed Trust," which came over from the United States of America in the late 'twenties of this century, largely as a selling proposition. The object of the Fixed Trust is more or less completely to eliminate the human element in administration, while retaining the advantages of a certain spreading of investments. The Fixed Trust, as a rule, is not a company. It has no capital. Its "securities" are in the nature of deposit receipts to bearer, and carry the right to a proportionate share in a "unit" issued against the deposit with trustees of a diversified block of stocks and shares.

For example, in the case of a Fixed Trust whose certificates were the first to be introduced into Great Britain, the "unit" represented the investment of about £4,000 in 30

different equity stocks, in companies located in ten countries, and exploiting thirteen different industries. The British stocks in the "unit" were five Prudential "A's," twenty British American Tobacco, fifty Bass, and fifty Courtaulds. Each "unit" was divided into 1,000 sub-units of approximately £4, and investors were offered the opportunity of buying blocks of 5, 10, 25, 100, and 1,000 sub-units. Every half-year the trustees (in this case, a bank in Switzerland) were to distribute all accumulated dividends, together with the monies accruing from bonus share distributions, rights and "split-ups," which were in every case to be sold for what they would fetch in the market. The purchase price of the certificates was based, at any given moment, on the market price of the component securities, *plus* various other costs—including a dividend equalization fund of 5 per cent —and trustee charges. The period of the trust agreement was 25 years.

This is a fairly typical example of a Fixed Trust, though the main idea admits of endless variations. Many of the Fixed Trusts of the United States of America, for instance, have limited their holdings to North American securities. Trusts can be formed, again, with holdings limited to particular groups, such as Electrical shares. The advantages claimed for Fixed Trusts by their sponsors may be summarized as follows—

(1) The investor knows exactly where his money is being invested. His interests are well spread. The component stocks are held out as the pick of the market, and their combined figures make an imposing showing. A well-known American Fixed Trust, for example, laid much stress, in its prospectus, on the fact that its "units" represented ownership of shares in 28 American corporations, with an average age of fifty-six years, controlling 1,600 subsidiaries, and possessing total assets of $23,000 millions.

(2) All is fair, square, and above-board. There can be no

speculation, no directorial scandals, and no errors of management. The conduct of the trust is purely a matter of routine administration, on rigid rules laid down in advance. The investor, if he wishes, can cut out the trust altogether, at any time, by paying up the current charges for a full unit and becoming himself the beneficial holder of the stocks comprised in it.

(3) The choice of stocks being deliberately restricted to "winners," their average progress in the years preceding the trust's formation can readily be shown to be remarkable. Thus, if one of the largest American Fixed Trusts, actually set up in 1929, had been formed in 1912 (*with the knowledge of* 1929), the average annual distribution on its $10 shares in the next seventeen years would have been $1.32 or 13.2 per cent.

This is a fair statement of the main points in the case made out by supporters of the Fixed Trust. There is, however, another side to the picture. Certain serious criticisms may be made of the Fixed Trust from a market point of view—

(1) The expenses incidental to the purchase of a Fixed Trust unit are high. In the case of one Fixed Trust formed in Great Britain the expenses by way of "service charge," commissions, promoters' profits, etc., were between 7 and 8 per cent of the market value of the unit. Compared with the ordinary expenses of acquiring a well-spread individual investment portfolio, these charges are formidable. Obviously, if the investor wishes to re-cash his holding, this is a relevant consideration.

(2) If any component stock fails to realize expectations, many trusts, under their rigid rules, cannot sell out till an Ordinary dividend has been passed. In many cases they must then sell, willy-nilly, within a prescribed period—such as one hundred days. Thus they will always tend to sell *at the bottom of the market*. The more numerous Fixed Trusts

become, the more damaging this factor. For instance, some hundreds of Fixed Trusts formed in the United States held shares in broadly similar groups of companies. A single trust claimed to have sold $145 millions of its securities in two years. This figure in itself suggested to conservative investors the danger of a combined bout of compulsory selling, if a single popular "component" company happened to pass its dividend. Some of the later trusts, having this possibility in mind, adopted more scientific criteria of "saleworthiness," and left greater discretion in the hands of their managers. *Pro tanto*, they reintroduced the "human element," the elimination of which was the Fixed Trust's *raison d'être*.

(3) Imposing "past records" of Fixed Trusts are pure arithmetical exercises. Anyone can job backwards. What is the use of calculating one's hypothetical winnings if one had but known in advance which horses would be first past the post? A trust formed in 1912, with the knowledge of 1912, would not have picked the same securities as a trust formed in 1932. One cannot assume that the "winners" in Year I will head the field in Year XX.

(4) The only reason for making the trust "fixed" is the elimination of the human director. But fifty years of investment trust practice in England and Scotland suggest that it is ridiculous to assume that directors must needs be either fools or rogues, and that their brains, on the contrary, are the investor's chief asset.

(5) If a Fixed Trust sells all the bonus shares, rights, etc., obtained on its component securities, and pays the proceeds in cash to the investor, the latter's share of the total equity in the component companies becomes progressively less as time goes on, unless he re-invests these "capital" receipts.

(6) If a Fixed Trust has its headquarters in a foreign country, and holds securities of concerns in numerous other countries, a shareholder may be in danger of being mulcted for double or treble taxation.

So much for the detailed disadvantages of Fixed Trusts. The really decisive objections to this type of financial organization are of a more general character. In the first place, practically every Fixed Trust limits its securities to holdings of equity shares. The "ballasting" of investment trust portfolios on the orthodox British model by holdings of Bonds, Debentures, and Preference shares (representing, say, two-thirds of the total portfolio), is lacking in the case of the Fixed Trust. The prices of the latter's securities, consequently, will be liable to wide market fluctuations. The mere "spreading" of investments over different industries or different countries does not overcome this disadvantage. Cyclical fluctuations in share values and in business profits tend, under modern conditions, to occur more or less simultaneously in many branches of industry throughout the world.

In the second place, the Fixed Trust stereotypes a list of investments—drawn up at a moment whose choice is purely fortuitous—in a world of rapidly changing economic conditions. Industries rise and fall, demand shifts in incalculable fashion from one product to another, new inventions alter the outlook for whole markets, industrial dynasties die out and new powers arise. A British investor needs but to take heed of the "devastated" industrial areas of his country, which imponderable changes in world markets have left denuded of their former prosperity, in order to realize the danger of assuming that the best companies and industries to-day will be the best in twenty or twenty-five years' time.

A comparison of the varying experience of British investment trusts, on orthodox lines, formed before and since the Great War, suggests that their financial strength has not automatically followed the "spreading" of their investments. It has largely reflected their policy of making large annual reserve appropriations against the "book cost" of

securities. The prominently prosperous British "management" trusts, to-day, have steadily ploughed the profits of past years back into their businesses. Fixed Trusts, by contrast, usually set out to distribute all their receipts, apart from a small "equalization reserve" contributed by the investor himself.

Finally, the management trust, in the long run, tends to obtain its securities on better terms than the Fixed Trust. It purchases many of its investments on "underwriting terms," and in other ways takes advantage of its position as a corporate buyer. The Fixed Trust buys at market prices. Its unit embraces only small quantities of each constituent stock, and an investor can demand a new unit at any time. Consequently, the Fixed Trust (or, rather, the investor himself) will tend to pay commissions at maximum rates, with special expenses for "odd lot" dealings.

This brief review suggests the necessity for the most careful inquiry into the nature and implications of Fixed Trust finance. At a first glance, the method has many attractions. It is only when one examines its underlying features more closely that its defects become apparent. It is, perhaps, significant that the birthplace of the Fixed Trust is not Great Britain, with her long experience of investment trust practice, but America, where the investment trust is a sensitive plant of a few years' growth.

CHAPTER XVIII

TAXATION OF COMPANY EARNINGS

THE State as a third partner in all enterprises—Deduction of tax "at the source"—Investors' right to "personal reliefs"—Company assessments—Effect on published profit figures—Reducing "gross" to "net" and *vice versa*—Correction of earnings figures according to treatment of taxation in company accounts—Four methods—Repayment claims—"Tax free" and "tax compounded" dividends.

BEFORE the main conclusions suggested by this survey of investment methods and problems are summarized, consideration must be given to a subject whose relevance begins in the investor's cradle and pursues him beyond the grave. It has been laid down in earlier pages that any investigation of the investment value of an Ordinary share must be based upon the ascertainment of earning power, in relation to effective Ordinary capital, over a number of years. Rules have been suggested for the deduction of various items of expenditure—direct and indirect, actual and deferred—from receipts in order to arrive at a uniform basis for the concept of earning power. What allowance should be made, in this connection, for the peculiarly troublesome and unpopular species of expenditure known as taxation?

For nearly a hundred years, the State has been an invisible partner in every British enterprise, but its liability has been "limited" in one-sided fashion. It has shared in profits whenever they have been earned, and in losses to the extent that these have offset earlier gains, according to various formulae, weighted in its own favour rather than that of the tax-paying companies. Its interests, however, have never been extended below zero. Being a dividend-recipient without being a shareholder, it has had no capital to lose. Whenever its receipts, taken as a whole, have appeared insufficient for its growing needs, it has seldom hesitated to

ask Parliament for power to demand a larger "dividend," and Parliament has never had the heart to refuse it. Income-tax, whose "standard rate" immediately before the Great War was 1s. 2d. in the £, has since fluctuated violently having been as high as 6s. and never lower than 4s. During and after the War other forms of taxation were levied on earnings, such as Excess Profits Duty and Corporation Profits Tax, but these were swept away a few years after the conclusion of hostilities. High income-tax, which came as a similarly temporary guest in the first place, has remained as the Old Man of the Sea of British industry. Its incidence on company profits should be clearly understood by every investor.

The cardinal features as regards its collection, from the investor's viewpoint, are, first, that it is levied on the incomes of *persons*, and, secondly, that it is deducted, in the great majority of cases, *at the source*. In other words, if A makes a payment to B for the use of his property or other capital, B as the *recipient* of the income is liable to tax, but A, the *source* of the income, hands over the tax to the State. Thus B receives an amount calculated "before tax" (or "gross"), but paid to him "after tax" (or "net"). The chief exceptions to this rule are salaries and wages, which are almost always paid "gross," and the interest on certain British Government stocks, such as Four per Cent Funding Loan and Five per Cent War Loan. Interest on the former is handed over to recipients "before tax" when a declaration of foreign ownership has been made, and on the latter in all cases where the Treasury has not received instructions to the contrary. This is due to the historical accident that, at the time of issue, the Government was anxious to obtain, and retain, as many subscriptions as possible from non-residents in the United Kingdom. Incidentally, the Bank of England, as the Government's paying agent, does not deduct tax from annual interest payments of under £5 to

any one individual, in respect of any single Government stock. "Surtax"—which is a supplementary tax levied on a graduated scale, on incomes above a specified level—is paid direct by the recipient, and not "at the source."

Every investor has a right to the benefit of certain "personal reliefs" in respect of income-tax. Part of his total income escapes tax altogether (by the operation of various allowances in respect of children, dependants, "earned" income, etc.), part of his "taxable income" is liable at less than the standard rate, and from the remainder allowances may fall to be made, within a given limit, for life assurance premiums or contracts for deferred annuities.

As it is no part of the duty of company directors and accountants, who pay out dividends *after deducting tax at the standard rate*, to inquire into the circumstances of individual shareholders, it may frequently happen that small investors receive less than their due, since the operation of their "personal reliefs" may relieve them of tax on part, or even the whole, of their dividends. Their procedure, in such a case, is to apply to the nearest Inland Revenue office for a tax-repayment form, to furnish the required particulars, and to claim a refund of surcharge. Many investors of modest income remain in ignorance of their rights, and tacitly acquiesce, year after year, in the aggregate payment to the State of large amounts to which it has no legal claim. It is only fair to point out, in passing, that this is in no sense the fault of local income-tax officials. They are at all times ready to explain the true position to any taxpayer who takes the initiative in approaching them, and no investor should hesitate to seek their advice, personally, on any matter.

Now, a company, in the eyes of British law, is a "person," and its relations with the tax authorities are not discharged when it has merely remitted taxation, at the standard rate, on its dividends. The authorities assess its total profits,

each year, at a certain figure, which may or may not be identical with the net earnings shown in its accounts. The Inland Revenue Department lays down somewhat rigid rules as to permissible and non-permissible deductions for "expenses," and its allowances for "wear and tear," as has already been suggested (see Chapter XIII, page 126), are not always identical with those which a conservative board of directors would regard as adequate for "depreciation" and for "obsolescence."

Whatever the figure at which a company's profits are ultimately assessed, however, it is liable to pay over to the authorities the appropriate tax on the whole sum. In respect of the proportion distributed as dividends, it remits tax on behalf of the beneficiaries, i.e. the shareholders. As regards amounts "retained in the business," its liability to taxation is direct and personal.

Investors who bear this distinction in mind will have no difficulty in appreciating the correct policy to follow in allowing for the effect of income-tax on published company earnings. It is theoretically possible to maintain that the law is correct in regarding income-tax, not as an expense, but as an appropriation of earnings. It is invariably assessed as a *proportion* of net profits, and the liability for its payment arises only *after* profits have been made. Elsewhere in this book, however, it has been suggested that the term "net earnings" should be reserved for amounts remaining, in respect of any given year's operations, after all deductions which a company is required to make to *outside* persons or authorities, in respect of that year. "Net Profits," in the sense used throughout these pages, are profits which directors may pay out to their own shareholders, or retain inside the business. Now, it is clear that they have no such discretion in respect of amounts due for income-tax. Even cumulative Preference shareholders have no power to sue a company for unpaid dividends if their directors have not declared them.

But the Inland Revenue is a *creditor* for tax, and can apply to the Courts for power to distrain on a company's property if its claims, duly assessed, are not promptly met.

Investors who desire to compile earnings records, on the lines discussed on earlier pages, may therefore be advised to regard income-tax as an expense to be deducted before arriving at "Net Earnings" for any year, even though the actual payment may not be made until the following year, or even later. Their efforts will be directed towards the setting-out of profits *clear of all tax*. When these are duly separated (as previously suggested) into "Amounts Paid Out in Dividends," and "Amounts Retained in the Business," the former will show the total actually received, free of all liability, by shareholders subject to income-tax at the standard rate. If any individual proprietor is liable at less than the standard rate (on the one hand), or is assessed to surtax (on the other), it is no affair of the company. The total "Retained in the Business" will be available in its entirety as an addition to effective capital. It would obviously be misleading to describe £1 of earnings "ploughed

CONVERSION OF "GROSS" TO "NET"

Standard Rate of Tax (Per £)	To Reduce "Gross" Figures to a "Net" Basis, Multiply the Former by	Standard Rate of Tax (Per £)	To Reduce "Gross" Figures to a "Net" Basis, Multiply the Former by
s. *d.*		*s.* *d.*	
1 2	0·9417	4 5	0·7792
2 0	0·9000	4 6	0·7750
2 6	0·8750	4 7	0·7708
3 0	0·8500	4 8	0·7667
3 6	0·8250	4 9	0·7625
4 0	0·8000	4 10	0·7583
		4 11	0·7542
4 1	0·7958	5 0	0·7500
4 2	0·7917		
4 3	0·7875	5 6	0·7250
4 4	0·7833	6 0	0·7000

back" as being of equal practical service to £1 obtained from a public issue of capital, if the former, unlike the latter, were subject to a subsequent deduction of several shillings.

To reduce amounts shown "subject to tax" to their equivalents "after tax," the table given on page 202 will be found useful.

Thus, suppose the M.Q. Company, Limited, has a paid-up capital of £1,000,000, consisting of £400,000 in 7 per cent Preference shares, and £600,000 in Ordinary shares. In Year X, the company earns £120,000 (before tax), pays out dividends of £28,000 on its Preference and £60,000 on its Ordinary shares, and adds £32,000 to General Reserve and "Carry Forward." Its earnings available for Ordinary shareholders are £92,000 (i.e. £120,000 less £28,000 Preference dividends), equal to 15·33 per cent on its paid-up Ordinary capital. The dividend is at the rate of 10 per cent, and the total retained in the business apparently represents an effective addition of 5·33 per cent to the Ordinary capital.

All these figures, however, are expressed on a "gross" basis. If the standard rate of income-tax during Year X is 4s. 6d. in the pound, it is necessary to multiply each of them (except the paid-up capital totals) by 0·7750 in order to reduce them to a "net" basis. The results for the year, after allowing for tax, are then—

Paid-up Capital (*After Tax*)	7% Preference	£400,000
	Ordinary	£600,000
Total Earnings		£93,000
Preference Dividends		£21,700
Earned for Ordinary	Amount	£71,300
	Rate on Paid-up Capital	11·88%
Paid on Ordinary	Amount	£46,500
	Rate on Paid-up Capital	7·75%
Retained in the Business	Amount	£24,800
	Rate on Paid-up Capital	4·13%

The next table may be useful to investors who desire to carry out the reverse operation, i.e. to convert amounts expressed "after tax," into their equivalents "before tax."

This operation is necessary, for example, when a taxpayer is making his annual return of income. The authorities require "Dividends, Interest, Annuities and Other Income Subject to United Kingdom Income-Tax at the Source" to be written up to the appropriate amounts receivable *before* tax.

CONVERSION OF "NET" TO "GROSS"

Standard Rate of Tax (Per £)	To Raise "Net" Figures to a "Gross" Basis, Multiply the Former by	Standard Rate of Tax (Per £)	To Raise "Net" Figures to a "Gross" Basis, Multiply the Former by
s. d.		*s. d.*	
1 2	1·0619	4 5	1·2834
2 0	1·1111	4 6	1·2903
2 6	1·1429	4 7	1·2973
3 0	1·1765	4 8	1·3043
3 6	1·2121	4 9	1·3115
4 0	1·2500	4 10	1·3187
		4 11	1·3260
4 1	1·2565	5 0	1·3333
4 2	1·2632		
4 3	1·2698	5 6	1·3793
4 4	1·2766	6 0	1·4286

In applying these tables to the published accounts of British companies, investors will experience a certain difficulty, arising out of the fact that methods of presentation are by no means uniform. Investors should remember two things: first, that the aim of their analysis, as already stated, is to show *all* earnings items clear of all tax; and, second, that the accountants of a company may quite conceivably be unaware of its exact liability to income-tax on any given year's profits at the time when the accounts are presented to shareholders. The allowances they consider it prudent to make for expenses are frequently not identical with those allowed by the tax authorities. For example, the scales of permissible deductions for depreciation, are, to say the least, niggardly. A business which wrote off each year

merely allowances on the income-tax scale might soon find itself in a serious financial position. If a company earns £100,000 of gross profits, and deducts £10,000 for depreciation at an "economic" rate, of which the Inland Revenue authorities allow only £6,000, the accounts furnished to shareholders will show "Net Profits, after Depreciation," at £90,000, but the company will actually be assessed for tax at £94,000. The earning of profits and the payment of tax, again, do not exactly coincide in point of time. In Year X, a company may actually pay out cash in respect of taxation on the profits earned in Year (X-1), or, possibly, on the earnings for that year, *less* an allowance for losses made in Year (X-2).

The investor must use his own discretion in particular cases, bearing in mind that he may frequently be unable to discover the exact amounts paid or payable in taxation, and must make the nearest approximation which the data allow. His first care, in every instance, should be to distinguish the method used by the company under his observation in setting out its figures. The following are some of the more common expedients—

Case I. A company's liability to taxation is estimated, and charged against the profits of the year in question.

This, of course, is the simplest of all possible cases from the investor's viewpoint. The figure shown in the accounts for "Profits, less Estimated Taxation Thereon" (or words to that effect) ostensibly furnishes the investor with the precise information he desires. In practice, the results, from an outside inquirer's point of view, tend to be less exact than might be imagined. If the amount of the liability has not been agreed with the tax authorities at the time the accounts are drawn up, the directors and their officers, following accountancy's golden rule, will tend more or less consciously to *over-estimate* its eventual total. Consequently, when the latter has been assessed and paid over, a balance

may remain with the company. If the process is repeated, over a number of years, quite a handsome "internal taxation reserve" may be amassed. Possibly, in a subsequent period of trade depression and low current earnings, this reserve may be drawn upon, and if the fact is not disclosed in the published accounts, contemporary profits may appear greater than they really are. A criminal *cause célèbre*, in the year 1931, drew widespread public attention to the implications of such a practice—which had not previously lacked defenders—and the consensus of professional opinion now appears to be that published accounts should at least disclose the fact that a draft on reserves has been made, even if its exact amount is not stated. It is scarcely necessary to say that the investor, who is concerned with amounts actually earned each year, should leave outside his calculations all sums described as having been "Appropriated from Amounts Set Aside for Taxation in Previous Years, No Longer Required."

Case II. Amounts actually paid in taxation during the course of a year are charged against the profits of the year during which they are remitted.

Under this method, a company which closes its accounts on 30th June in Year X may pay its income-tax to the collector, say, in January of Year (X + 1). It will then, in due course, show profits earned for the twelve months to 30th June, Year (X + 1) *less* income-tax for Year X. The investor will be fairly safe in accepting the company's published "net" figures, so long as profits are relatively steady from year to year. If, however, as commonly happens, earnings show considerable annual fluctuation, the "net" returns in the accounts will appreciably understate true profits in "bad" and overstate them in "good" years.

For example, suppose the F.G. Company, Ltd., using this method, earned the following amounts, before tax, over a six-year period:—

	Profit before Tax
	£
Year I	250,000
Year II	400,000
Year III	700,000
Year IV	800,000
Year V	10,000
Year VI	300,000

Let it be supposed, further, that the standard rate of income-tax throughout the period is 4s. in the £, that the profits assessed for tax are identical with those arrived at by the company's accountants, shown above, and that taxation is *paid* each year on the profits earned in the preceding year and deducted as a current expense in the published annual accounts. Then, in Year II, the company will remit £50,000 in taxation on £250,000 of profits earned in Year I. The former amount, charged as an expense against the gross profits of Year II, will reduce those profits, as shown in the accounts of that year, to an ostensible net figure of £350,000. The following table shows, in respect of all the years in the table: first, the amounts handed over to the tax collector during the course of each year; and, second, the totals described as "Net Profits After Taxation" in the company's published accounts—

	Amounts Remitted to Tax Authorities in the Course of Each Year	Amounts shown as "Net Profits" in Annual Accounts, after Deducting Taxation as a Current Expense
	£	£
Year II	50,000	350,000
Year III	80,000	620,000
Year IV	140,000	660,000
Year V	160,000	*Loss* 150,000
Year VI	2,000	298,000

If the figures in the last column are compared with those of the previous table, it will be seen that during Years II

and III, when profits were rising sharply, the company, each year, paid tax on appreciably less than it earned, so that shareholders obtained an exaggerated idea of the true rate of progress of its *net* profits. In Year V, the company was badly hit by a slump in general industrial activity. Though it succeeded in earning profits sufficient to meet all trading expenses and to leave a small balance on the right side, it was compelled to remit income-tax on the earnings of the preceding "boom" year. Consequently, its accounts showed a formidable debit balance as an ostensible result of the year's "trading." In Year VI, the extent of its recovery, for converse reasons, was greatly exaggerated. Its gross profits increased by £290,000, but its net profits were shown as having risen by as much as £448,000 since the income-tax payment of the year was based on the very low earnings of the year of depression.

The misleading impression afforded by the application of this method to fluctuating gross profits will be evident if its results, in the case of the imaginary F.G. Company, are contrasted with those obtained under Case I, after each year's tax has been correctly estimated, and charged against the profits in respect of which it is payable—

Yr.	Case I			Case II		
	Net Profits After Deducting Tax	Increase (+) or Decrease (−) as Compared with Previous Year's Figure	Rate of Tax Actually Charged Against Profits of Each Year	Net Profits After Deducting Tax	Increase (+) or Decrease (−) as Compared with Previous Year's Figure	Rate of Tax Actually Charged Against Profits of Each Year
	£	£		£	£	
II	320,000	+ 120,000	4s. in £	350,000	—	2s. 6d. in £
III	560,000	+ 240,000	4s. in £	620,000	+ 270,000	2s. 3·43d. in £
IV	640,000	+ 80,000	4s. in £	660,000	+ 40,000	3s. 6d. in £
V	8,000	− *632,000*	4s. in £	*Loss 150,000*	− *810,000*	£16 in £
VI	240,000	+ 232,000	4s. in £	298,000	+ 448,000	1·6d. in £

When profits are fluctuating, in short, Case II affords results which, from the investor's viewpoint, are utterly misleading. Whenever a company, therefore, discloses in

its accounts both its gross income and the *total* taxation charged against it, investors should be prepared to go to the trouble of ascertaining whether Case I or Case II applies, and, in the latter event, of recalculating the figures on the basis of Case I. The various steps in the practical working are—

(1) Set out the standard rates of income-tax for each of the years under review.

(2) Compare the "amounts of taxation" charged each year with the gross disclosed profits of the company under review, and calculate *how much in the £ has actually been charged.*

(3) If the figures of "rates paid" are approximately those of the standard rates applicable to the several periods, it may be presumed that the company has applied Case I, and its *net* figures can be accepted as they stand. The degree of correspondence between the "standard" and "calculated" rates of taxation need not be absolute. Small differences may be attributed to variations, as regards amounts charged under certain heads of expenditure, between "economic" profits and "assessed" profits for income-tax purposes.

(4) If the differences between the "standard" and the "calculated" rates are considerable, and the calculated figures tend to be less than the standard figures when profits are rapidly rising, and greater than the standard rates when profits are falling, there are *prima facie* grounds for suspicion that the method of Case II is being applied. The investor, in such an event, will obtain a much more reliable idea of the real trend of profits by ignoring the amounts actually charged, calculating the sums chargeable for each year at the standard rates, under Case I, and deducting these from the gross disclosed profits for the years to which they are applicable. The "net" figures thus obtained alone should be used as a basis for subsequent calculations of earning power, etc.

(5) If the published accounts do not reveal how much has been charged for taxation, but purport to give merely a "net" figure, investors have no means of discovering upon what basis tax has been deducted. If a tactfully-worded request to the company produces a reply disclosing not necessarily how much has been written off, but whether Case I or Case II applies, a few simple arithmetical operations will enable the investor roughly to "add back" tax, to arrive at gross profits, and to recalculate true net earnings as described in (4) above. If the company, in its wisdom, refuses to supply information, the rest, necessarily, is silence.

Case III. A reserve for taxation is created, replenished from time to time out of profits, and charged with income-tax payments, as and when they are made.

This method is popular among prudent directors who desire to minimize the disturbing effects of business fluctuations on the financial structure of their companies. Reference to the figures of the F.G. Company, Ltd., instanced on page 207, will show that, over a six-year period, the company's annual tax-liability varied between £2,000 and £160,000, presuming a standard rate of tax of 4s. in the £ throughout. In practice, standard rates of taxation have been changed frequently since the War. During the ten years ended December 31st, 1931, the standard rate was changed five times, as shown—

	Standard Rate
Beginning of 1922	6s. in £
Subsequent Changes—	
Budget of 1922–23	5s. in £
Budget of 1923–24	4s 6d. in £
Budget of 1925–26	4s. in £
Budget of 1931–32 (April, 1931)	4s. 6d. in £
Supplementary Budget of 1931–32 (September, 1931)	5s. in £

Income-tax fluctuations are the more embarrassing because altered changes in the standard rate tend to coincide with

periods of industrial depression and reduced company earnings, owing to a vicious chain of causation which need not be discussed here. The creation of a strong reserve is much the most satisfactory way of safeguarding a company's finances against the disturbing and potentially dangerous consequences of variations in amounts paid to the tax collector. In fat years, the reserve may receive a handsome allocation; in lean years, it may be drawn upon to meet part, or even the whole, of a company's tax liability.

Unfortunately, outside investors seldom know the dimensions of the taxation reserve at any given moment, since it is usually lumped together, in the published balance sheet, with other items under the general heading of "Creditors." If a company discloses its gross profits figures, together with the amounts set aside out of gross profits for taxation reserve, the problem of approximately ascertaining true net earnings is fairly simple. The amount of taxation payable on the gross figures, at the standard rate, is calculated, and deducted from gross profits. If the company has been replenishing its taxation reserve, the residual figure will be higher than that shown as "net profits" in the amounts. The amount of the excess should be added, in subsequent analyses, to the total earnings "left in the business" (i.e. regarded as an accretion of "capital effectively employed"). If the company has been drawing on its taxation reserve, the apparent difference between the two figures should be deducted from earnings "left in the business." If the company does not reveal its gross profits, but merely publishes a net figure, the investor is left as one who whistles for the wind.

Case IV. Amounts paid in dividends are shown before deduction of tax, and amounts "retained in the business" after deduction of tax.

This practice is followed by far too many companies for the average investor's liking. Its frequent use may be ascribed partly to accounting convenience, and partly to

its correspondence with the legal position under whic liability to tax on dividends, as previously mentioned, rest with the recipient shareholders (although the compan actually makes the deduction), while the liability on profit "retained" rests with the company itself. Unhappily, th method gives published accounts a piebald appearanc the so-called net profits being shown partly before an partly after deductions of tax. If the earnings ratio is cal culated on this basis, there is a liability to overstatement which increases with the proportion of dividends to tota profits. An example will make this point clear.

Suppose there are two companies, called, respectively Little Reserves, Limited, and Big Reserves, Limited. Bot have a paid-up capital of £5,000,000 in Ordinary shares and each, in Year X, makes a profit, before tax, of £1,000,000 Income-tax is paid at a standard rate of 4s. 6d. in the £ absorbing £225,000, and leaving a net profit of £775,00 in each case.

Suppose, further, that the directors of Little Reserves Ltd., believe that heaven sends profits to be divided, an decide to pay out the whole of the year's earnings in a divi dend of 20 per cent, subject to tax. Big Reserves, Ltd.

Little Reserves, Limited	£	Big Reserves, Limited	£
Ordinary Capital	5,000,000	Ordinary Capital	5,000,00
Profits before Tax	1,000,000	Profits before Tax.	1,000,00
Dividend of 20 %	1,000,000	Dividend of 10%	500,00
Less Tax at 4s. 6d.	225,000	Less Tax at 4s. 6d.	112,50
Net Dividend	775,000	Net Dividend	387,50
		Retained in Business	500,00
		Less Tax at 4s. 6d.	112,50
		Retained, Net	387,50
Total Net Earnings	£775,000	Total Net Earnings.	£775,00

having a conservative tradition, distributes only 10 per cent subject to tax, and leaves the remainder in the business. The reports are then drawn up for shareholders, showing dividends *before* and retained earnings *after* deduction of tax. The preliminary working, carried out by the respective accountants, is given in the table at the foot of page 212.

Shareholders, however, do not see this table. The reports presented to them are drafted thus—

Little Reserves, Limited	£	Big Reserves, Limited	£
Ordinary Capital . .	5,000,000	Ordinary Capital . .	5,000,000
Net Profits . . .	1,000,000	Net Profits . . .	887,500
Dividend of 20% (Subject to Tax) . . .	1,000,000	Dividend of 10% (Subject to Tax) . . .	500,000
		Retained in Business .	387,500
	£1,000,000		£887,500

Although earnings are identical in both cases, nine out of ten commentators will assume that Little Reserves has enjoyed a more profitable trading year than Big Reserves, having earned 20 per cent (£1,000,000) on its paid-up capital, while Big Reserves has earned only 17·75 per cent (£887,500).

Investors should be on their guard against this exceedingly common error. Their *modus operandi* should be: (1) To examine the amounts shown as dividend on each class of shares, and to ascertain whether these are shown gross or net; (2) if the figures are given gross, to deduct the relevant amount of tax at the standard rate, from both dividends and net earnings. In some cases, it may then be necessary to re-examine the amended "net earnings figure" to discover whether any further adjustments are required on the lines already described.

Thus, in the case above, inspection would reveal that the dividend of Little Reserves, Ltd. (£1,000,000), was

exactly 20 per cent of the Ordinary capital (£5,000,000)—
ate described in the accounts as being subject to tax
Deduction of tax at 4s. 6d. on £1,000,000 would reduc
both dividend and earnings by £225,000 to £775,000 (15·
per cent) on a true net basis. Similar inspection of th
igures of Big Reserves, Ltd., would show that the dividen
if £500,000 had been charged gross, and deduction of ta
it 4s. 6d. would reduce the total dividend by £112,500 t
£387,500 and the total earnings by the same amount t
£775,000.

Suppose, finally, that the accounts of Big Reserves, Ltd
described profits as having been struck after setting asid
£x for "Taxation Reserve," while those of Little Reserve
Ltd., showed earnings after the transfer of an undisclose
amount from "Amounts Previously Set Aside for Taxatio
No Longer Required." The application of the procedu
described under Case III would then enable the investor t
arrive at the true final earning power of Big Reserve
Against the Little Reserves figure he would enter a *cavea*
since it would be dangerous to accept, at its face value,
figure which exaggerated the company's real earnings.

Taxation is a difficult subject, which adds unwelcom
complication to the task of measuring earning power fo
investment purposes. To endeavour to take short cut
however, by accepting all company figures in the form i
which they are published, is highly dangerous in view o
the onerous nature of present-day taxation, and the diversit
of methods adopted for its provision. In point of fact,
short experience will develop surprising facility, on th
investor's part, in discovering exactly what procedu
has been followed in any particular case, and in arrivi
at results as nearly exact as the data will allow.

A final point remains to be considered before leaving th
subject of taxation. Investors who are not subject t
income tax, or to tax at the full rate, should not omit

claim repayment whenever they receive a dividend from which tax has been deducted. If they are shareholders in a company like British American Tobacco, which pays its dividends "tax free," they are nevertheless entitled to repayment of tax. A "tax free" dividend of 10 per cent, with a standard rate of income-tax of 4s. in the £, is identical in all respects with a dividend of 12·5 per cent "subject to tax." The chief exception to this rule arises in the case of dividends or interest on shares and deposits in Building Societies, which are almost invariably advertised as being "free of tax." Most societies have arrangements with the Inland Revenue. Many of their members being small investors, the taxation authorities would be called upon to deal with a host of repayment claims if the ordinary procedure were followed. The Treasury therefore compounds with the Societies, except in regard to the larger holdings, in respect of which the taxation authorities exact their due pound of flesh.

CHAPTER XIX

CONCLUSION

INVESTMENT is a territory which has been frequently explo
but seldom surveyed. Discoverers (whose numbers inclu
most men outside the workhouse), have been generally t
anxious, as it were, to reach the North or South Pole
High Income or Capital Appreciation, to spend much ti
with theodolites in the *terrain* through which they ha
passed. The aim of this book has been to exhibit at le
some of the main contours on the chart for one importa
section of the territory—industry and trade in the hands
public companies. Obviously, there are still many mou
tains and valleys awaiting the later climber, many smal
rivers whose course is shown only by a dotted line, and mu
work for the geologist's hammer. But the outline of the co
tinent and its main arteries have been indicated, and t
conclusions suggested by the survey may now be summarize

In the first place, Investment is no El Dorado, whe
unlimited gold nuggets are available, like strawberries, f
the trouble of picking. Investment is a territory for t
colonist, not the prospector. The earth yields its increa
and human effort its reward, year in and year out, in
spectacular fashion. Parts of the territory may yield a
normally rich results to those who first enter them, b
rewards above the average invariably bring in other settl
and cannot be maintained in the face of the world-wi
levelling force of competition. High profits and high ris
are one and indivisible. The life of a pioneer is essential
speculative. Large gains and heavy losses cancel ea
other. The wayfaring man who sells his discretion f
alluring prospects of the former is generally left by h
buyers with unlimited quantities of the latter.

Before the investor parts with his money for any stock or share, he should clearly define his attitude towards the whole question of investment. His object is to achieve an income, not a fortune. If he desires to obtain, year after year, a return on his money far above the average, he must constantly be buying something for less than its economic price from those who do not know its true value, and selling it for more than it is worth to those foolish enough to pay the price. A few who are exceptionally well-informed, skilful, lucky or unscrupulous, may amass uneasy wealth by a succession of such operations—though it is easier to be consistently non-moral than consistently successful, and a single bad speculation may cancel out a host of remunerative ventures. The prosperity of a multitude of investors, however, cannot be built on such a foundation. The investor, as distinct from the speculator, hands over his resources to other people, whose business is to render services to the community for which the community is prepared to pay a fair price. It is his duty to assure himself that those to whom he confides the opportunity for national service will use it honestly and with reasonable skill and judgment, and will thus earn the right to continue to serve society.

This book has, therefore, been written, throughout, from the standpoint of the long-term investor, who desires to combine as much security of the principal of his capital as is consistent with life in a world where nothing is immortal, and a maximum return consistent with a reasonable prospect of permanency. Under both headings, the only sound working basis for personal judgment, in the long run, is an examination of the records of all candidates for financial suffrage over a sufficiently long period of time to reveal fundamental characteristics and eliminate temporary abnormalities. It is for this reason that preceding chapters have given much detailed concern to the elucidation of methods of measurement of various aspects of industrial finance.

The beginning and end of all things, for the investor, the "pool" which economists generally call "the nation income." To this pool all who produce goods and servic useful to man contribute, and from it all concerned dra their respective shares. Obviously, one cannot establi a claim on the "pool" for wealth, however potential valuable, which remains in the ground and never reach the surface, or for services, however well-meant, which t community does not want. Those alone have a right "income" who have fulfilled some need for which t nation, out of each year's aggregate income, is prepared pay. The investor's is not an active role. Having mac over one of the means of satisfying demand to those wh set themselves out as organizers of all other means to th end, the investor serves among those who stand and wai

When he has entrusted his resources to honest ar capable men, he can look forward to two main sources benefit, tempered by one main risk. So far as the Weste World is concerned, the great increase of population of t nineteenth century is slowing down or ceasing, but t march of scientific knowledge continues. Despite tempora recessions of greater or less severity, as a result of flaws economic machinery, the world's wealth and purchasi power will continue to increase, decade by decade. Estal lished companies, which secure their equitable share of a enhanced national income, will pass on the fruits of th increase to their proprietors. But in the future, as in t past, companies whose managements are skilful or ente prising above the average will tend to increase their sha in the general pool. If a man make a better mousetra than his neighbour, even though he live in the heart of t forest, the world, proverbially, will make a track to his doo The investor can judge a tree only by its fruits. The metho outlined in this book suggest means by which he may measu the ability of the managers of individual companies to mak

better mousetraps than their neighbours. It may be more advantageous to pay a high price for the shares of such companies than to pay any price whatever for those of second-rate concerns and, particularly, of new concerns. The world has every reason to be grateful for the services rendered by those who support new enterprises in infancy and adolescence, but that is speculative work, beyond the legitimate range of the average long-term investor.

The danger is that men die and industries die. No charts or figures will necessarily reveal that an old-established and successful business may have a presiding genius, whose death may leave its affairs in the hands of men of lesser ability, who may fall back upon the fatal expedient of second-rate minds—routine methods. The investor cannot take out an insurance policy against the possibility that a company prosperous in a moderate way may be a failure in a larger way of business, or be merged in a combine with a lower average of efficiency than its own. Above all, any company may fall victim to insidious changes in demand or fashion, which come sometimes imperceptibly over a generation and sometimes in the twinkling of an eye. No company can make profits by producing, with superlative internal "efficiency," something which the world no longer desires.

Investors may endeavour to minimize these risks by remaining outside industries whose position appears obviously transient, and above all, by refraining from falling into the error that the amount of capital which a company has expended in the past has any connection with the profits it will earn in the future. When all is said and done, however, there is no cut-and-dried method of escaping the consequences of economic evolution. The price of investment security, as of liberty, is eternal vigilance. Having bought a share, the investor must watch it. The methods outlined in this book will at least afford him earlier

intimation of fundamental changes than will be possessed b those of his colleagues who have neither opportunities fc obtaining "inside" news nor the inclination to follow mor reliable intelligence than market gossip.

If investment is to become a science, freed from th trammels of rigid legal dogma and the false ideals an disturbing irrelevancies of short-term speculation, a firs step must be a recognition of the basis of security for ever stock and share. The investor who buys a British Goverr ment stock obtains a first charge on the earning power c the whole nation. The purchaser of an Ordinary share buy the right to a fractional part of the equity in all futur earnings of a particular company, subject to the satisfactio of others whose rights rank prior to his own. It is illogica to assess the value of such a share either on a single dividen which the company in question has just paid, or the nex dividend it is considered likely to pay.

All companies are liable to intermittent profit fluctuation: of greater or less degree. But these are unimportant episode in the annals of progressive companies. It follows that th equity in a sound concern, which, taking good and ba trading years together, is steadily increasing its market an its profits, is precisely as valuable in a period of temporaril depressed earnings as in a "boom" year. It is sometime difficult for investors to appreciate this truth. The enormou extent of upward and downward changes in share value on the Stock Exchange, between good and bad times, attest the failure of the majority of operators to draw the necessar inference.

The investor's first task is to measure the long-term tren of a company's earnings, on the basis of sufficiently numerou and continuous past results to make the measuremen reliable. His second task is to act upon his judgment with out allowing his mind to be swayed by short-term fluc tuations. A purchase of an Ordinary share in a compan

with a steadily rising trend, at a price which offers the investor an immediate yield of only, say, 5½ per cent, may be a more profitable operation than an Ordinary share purchase in a company with a "flat" earnings trend, to yield an immediate 7 per cent. A purchase after an unusually rapid rise in earnings is almost always inadvisable. Few, if any, companies can maintain a "geometric" increase of earnings in perpetuity, so that a purchase made upon such a rise must almost inevitably be based on an exaggerated idea of the real trend. Further, as the market bases its views, for the most part, on short-term considerations, the price at which the purchase is made will be a "boom price." The investor, in other words, will "get in at the top." On the other hand, in time of temporary trade depression, it matters little to the long-term investor whether he "strikes the bottom of the market" or not, so long as his purchase, on a long-term trend basis, is made at an intrinsically reasonable figure.

Future systematic investigation in the field of scientific investment, accordingly, must resolve itself into a study of the concept of earning power. All scientific measurements are ratios. A figure is meaningless unless it is expressed in terms of some other figure. In investment, as in so many other objective sciences, one is concerned to measure the return on the expenditure of a given unit of energy. Steam pressure, for example, may be measured in pounds per square foot. What is the unit for comparison in the case of earning power? The answer is, obviously, the capital employed. Unfortunately, the measurements usually compiled on the investor's behalf are based on something quite different, namely, the "paid-up capital"—a legal figure which may be more or less than the effective capital in a business. Earlier pages of this book have dealt with the method to be followed in the ascertainment of as nearly exact a computation of "capital effectively employed" as prevailing

methods of company financial publicity permit. On this basis alone can reliable measurements be made.

That long-term earning power, expressed by reference to capital effectively employed, is the basis of all reliable investment measurement is the central theme of this volume. As regards other aspects of the main question, various conclusions have emerged whose implications deserve careful consideration alike by the investor and the market. It has been shown that the ownership of the capital of the average company has become diffused among small proprietors, comparable with an army in numbers but not in discipline or organization. A multitude of economic factors —including the development of "limited liability" investment, a century's growth of property, education and leisure, and the building up of a centralized market for the regular creation and transfer of securities—have tapped the remotest sources of new capital with extreme thoroughness and, *pari passu*, have all but completed the divorce of ownership from control. Future jurists may debate the question whether some form of representative government can be devised to enable heterogeneous bodies of shareholders to express a corporate will. Failing such a development their powers of ultimate endorsement or veto of the decisions of their permanent representatives, the directors, may be in danger of ultimately perishing through neglect.

In the meantime, the investor must squarely face the consequences of the present state of affairs. If he considers, at any time, that the policy followed by a company's directors is not in the best interests of the shareholders, he can look for little support from his fellow proprietors until matters have reached an advanced stage, when remedial measures may be ineffective. The only course open to him is to sell his shares—a step which may wound his self-respect but will protect his pocket.

Since the administrative powers of directors, in normal

times, are for most purposes, absolute, investors will be well advised to show the keenest personal interest in the personnel of the boards of their companies. However bright the prospects of a concern may appear to be, investors should give its shares a wide berth unless they are completely satisfied, after the fullest inquiry, as to the ability as well as the integrity of all the directors. Investors should have a clear idea in whose hands control really rests, and should distinguish men of action from figure-heads. Results, in the long run, are the best commentary on directorial ability, and published annual accounts, with all their imperfections, deserve the closest scrutiny by all who have money at stake. Various detailed measures of analysis and synthesis of company accounts have been outlined in earlier pages. Their application will not protect the investor against the effects of all ills which companies are heirs to, but it will at least afford him the earliest intimation he is likely to obtain of the existence of mortal diseases.

Finally, investors who are concerned, in the interests of security for their capital, with the relative merits of a purchase of Debentures, Preference shares or Ordinary shares should clearly understand how much they are relinquishing and how much they hope to gain, by bartering equity for priority rights. Interest on the best "secured" company investments can be paid, out of sources other than earnings, only for relatively short periods. "Charges" on capital assets are ineffective when the latter have become valueless. Thus the priority enjoyed by fixed-interest securities is best regarded as a protection only against short-term fluctuations in profits, and not against a permanently declining earnings' trend. In other words, the soundest Debentures and Preference shares are issued by companies whose Ordinary shares make the most effective appeal to the investor. The process of preliminary inquiry and analysis before purchase are identical, whether the

investor desires to become a fixed-interest security holder or an equity shareholder.

The price paid, further, is to be related to the nature of the security offered. The buyer of a Debenture or Preference share, in any case, relinquishes all direct claim on the fruits of future prosperity and progress. He should not simultaneously be required to give up too much in the way of immediate income. If, in the long run, the legal distinction between a Debenture and a Preference share tends to be illusive, and the real advantage of the one over the other is a matter mainly of relative priority, the case for the existence of Preference shares with large amounts of Debentures in front of them must be regarded as not proven.

Such are the general principles which may be applied to the selection of an investment portfolio by scientific rather than opportunist methods. In a work like the present, it is possible only to indicate their nature, and to leave to individual investors the task of applying them, in the light of the innumerable special considerations which surround the choice of any particular investment. If art be the application of the principles of science, the art of investment has as yet scarcely a definite existence. A certain "sixth sense" is the common prerogative of all artists whose ability stands out above that of their fellows. This will doubtless continue to be the hall-mark of the artist using money as his medium, as of the artist in stone or pigments, long after the laws of the science of investment have been formally enunciated, classified and conned by rote. About such a manifestation of genius no book will ever be written, for it is of the spirit.

The owners of a country's capital, however, are not a select band of artists, but an army of normal men and women. Poets are born, not made, but one need become a poet only from choice, whereas one is usually an investor, as one is a parent, willy-nilly. To approach the task with

reasoned ideas and a planned technique is to ensure wider benefits and fewer costly failures than are likely to ensue from unreasoning acceptance of either the advice of friends or the dictates of one's own emotions. The former are seldom disinterested; the latter, in money matters, are always dangerous.

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